SILICON STORAGE TECHNOLOGY INC
Form 10-Q
January 18, 2008

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

ý **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended June 30, 2007

OR

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from to
Commission File Number 0-26944

SILICON STORAGE TECHNOLOGY, INC.

(Exact name of Registrant as Specified in its Charter)

California	**77-0225590**
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification Number)
1171 Sonora Court, Sunnyvale, CA	**94086**
(Address of Principal Executive Offices)	(Zip Code)

(408) 735-9110
(Registrant's Telephone Number, including Area Code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes o No ý

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act (Check one):

Large accelerated filer o Accelerated filer ý Non-accelerated filer o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No ý

Number of shares outstanding of Silicon Storage Technology, Inc.'s Common Stock, no par value, as of the latest practicable date, December 31, 2007: 104,197,735.

SILICON STORAGE TECHNOLOGY, INC.

FORM 10-Q: QUARTER ENDED JUNE 30, 2007
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PART I FINANCIAL INFORMATION

Item 1. Condensed Consolidated Financial Statements (Unaudited)

SILICON STORAGE TECHNOLOGY, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

(in thousands, except per share data)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2007	2006	2007
	As Adjusted and Restated (Note 2)		As Adjusted and Restated (Note 2)	
Net revenues:				
Product revenues unrelated parties	$ 40,775	$ 35,554	$ 78,807	$ 74,687
Product revenues related parties	58,163	54,723	120,434	103,801
Technology licensing	8,791	9,035	17,641	18,258
Technology licensing related parties		31	1,378	121
Total net revenues	107,729	99,343	218,260	196,867
Cost of revenues:				
Cost of revenues unrelated parties	29,245	25,058	57,148	53,843
Cost of revenues related parties	51,071	48,692	100,027	90,910
Total cost of revenues	80,316	73,750	157,175	144,753
Gross profit	27,413	25,593	61,085	52,114
Operating expenses:				
Research and development	13,241	14,332	28,135	28,106
Sales and marketing	7,108	7,539	15,261	14,304
General and administrative	5,813	6,811	11,036	13,566
Other operating expenses		4,005		4,005
Total operating expenses	26,162	32,687	54,432	59,981
Income (loss) from operations	1,251	(7,094)	6,653	(7,867)
Interest income	999	1,669	1,337	3,467
Dividend income	66	186	165	218
Other income (expense), net	15	40	41	20
Interest expense	(65)	(113)	(106)	(202)
Gain on sale of equity investments		142	12,206	142
Impairment of equity investments			(3,523)	
Income (loss) before provision for income taxes and pro rata share of loss from equity investments	2,266	(5,170)	16,773	(4,222)

	Three Months Ended June 30,		Six Months Ended June 30,	
Provision for income taxes	855	418	2,978	1,164
Income (loss) before pro rata share of loss from equity investments	1,411	(5,588)	13,795	(5,386)
Pro rata share of loss from equity investments	233	1,931	472	3,447
Net income (loss)	$ 1,178	$ (7,519)	$ 13,323	$ (8,833)
Net income (loss) per share basic	$ 0.01	$ (0.07)	$ 0.13	$ (0.08)
Shares used in per share calculation basic	103,178	104,198	103,159	104,071
Net income (loss) per share diluted	$ 0.01	$ (0.07)	$ 0.13	$ (0.08)
Shares used in per share calculation diluted	104,397	104,198	104,468	104,071

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

SILICON STORAGE TECHNOLOGY, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

(in thousands)

	December 31, 2006	June 30, 2007
ASSETS		
Current assets:		
Cash and cash equivalents	$ 100,973	$ 104,157
Short-term available-for-sale investments	38,835	63,114
Trade accounts receivable unrelated parties, net of allowance for doubtful accounts of $112 at December 31, 2006 and $16 at June 30, 2007	19,382	14,689
Trade accounts receivable related parties	45,561	32,099
Inventories, net	73,883	53,431
Other current assets	9,074	7,231
Total current assets	287,708	274,721
Property and equipment, net	19,513	19,667
Long-term available-for-sale investments	45,554	38,166
Equity investments, GSMC	42,550	42,550
Equity investments, others	25,237	22,693
Goodwill	29,213	29,213
Intangible assets, net	9,940	8,838
Other assets	6,263	1,090
Total assets	$ 465,978	$ 436,938
LIABILITIES		
Current liabilities:		
Borrowing under line of credit facility	$ 3,070	$ 4,197
Trade accounts payable unrelated parties	31,148	21,443
Trade accounts payable related parties	36,510	22,925
Accrued expenses and other liabilities	24,115	18,831
Deferred revenue	3,390	3,461
Total current liabilities	98,233	70,857
Other liabilities	2,030	6,017
Total liabilities	100,263	76,874
Commitments (Note 7) and Contingencies (Note 8)		
SHAREHOLDERS' EQUITY		
Preferred stock, no par value:		
Authorized: 7,000 shares Series A Junior Participating Preferred Stock, no par value		
Designated: 450 shares Issued and outstanding: none		
Common stock, no par value:		
Authorized: 250,000 shares Issued and outstanding: 103,629 shares at December 31, 2006 and 104,198 shares at June 30, 2007	364,330	365,566

	December 31, 2006	June 30, 2007
Additional paid-in capital	61,533	64,828
Accumulated other comprehensive income	31,281	33,136
Accumulated deficit	(91,429)	(103,466)
Total shareholders' equity	365,715	360,064
Total liabilities and shareholders' equity	$ 465,978	$ 436,938

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

SILICON STORAGE TECHNOLOGY, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

(in thousands)

	Six Months Ended June 30,	
	2006	**2007**
	As Adjusted and Restated (Note 2)	
Cash flows from operating activities:		
Net income (loss)	$ 13,323	$ (8,833)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	4,982	5,446
Stock-based compensation expense	4,267	3,034
Provision (credits) for doubtful accounts receivable	323	(96)
Provision for sales returns	421	(109)
Provision for excess and obsolete inventories, write-down of inventories and adverse purchase commitments	8,814	6,264
Pro rata share of loss from equity investments	472	3,447
Impairment loss on equity investment	3,523	
Gain on sale of equity investments	(12,206)	(142)
(Gain) loss on disposal of equipment	(6)	1
Changes in operating assets and liabilities:		
Trade accounts receivable unrelated parties	(739)	4,899
Trade accounts receivable related parties	17,906	13,462
Inventories	4,898	14,083
Other current and non-current assets	(2,701)	1,827
Trade accounts payable unrelated parties	(15,880)	(9,761)
Trade accounts payable related parties	(76)	(13,529)
Accrued expenses and other liabilities	2,366	1,890
Deferred revenue	(403)	72
Net cash provided by operating activities	29,284	21,955
Cash flows from investing activities:		
Investments in equity securities	(3,000)	
Note receivable		(500)
Purchase of property and equipment	(2,359)	(3,738)
Proceeds from sale of equipment	9	
Purchase of intellectual property license	(317)	(741)
Purchases of available-for-sale investments	(33,699)	(35,474)
Sales and maturities of available-for-sale and equity investments	19,820	20,062
Net cash used in investing activities	(19,546)	(20,391)
Cash flows from financing activities:		
Debt repayments	(94)	
Borrowing against line of credit		1,036

	Six Months Ended June 30,	
Issuance of shares of common stock	1,374	1,236
Principal payments of capital leases	(602)	(652)
Net cash provided by financing activities	678	1,620
Net increase in cash and cash equivalents	10,416	3,184
Cash and cash equivalents at beginning of period	77,382	100,973
Cash and cash equivalents at end of period	$ 87,798	$ 104,157

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

SILICON STORAGE TECHNOLOGY, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF EQUITY

(Unaudited)

(in thousands)

	Common Stock		Additional Paid-In Capital	Retained Earnings (Accumulated Deficit)	Accumulated Other Comprehensive Income	Total
	Shares	Amount				
Balances, December 31, 2006	103,629	$ 364,330	$ 61,533	$ (91,429)	$ 31,281	$ 365,715
Issuance of shares of common stock under employee stock purchase and option plans	569	1,236				1,236
Stock-based compensation			3,034			3,034
Equity affiliate stock based compensation			261			261
Impact of adoption of FIN 48				(3,204)		(3,204)
Net loss				(8,833)		
Unrealized gain on available- for-sale securities					2,058	
Cumulative translation adjustment					(203)	
Comprehensive loss						(6,978)
Balances, June 30, 2007	104,198	$ 365,566	$ 64,828	$ (103,466)	$ 33,136	$ 360,064

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

SILICON STORAGE TECHNOLOGY, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. Basis of Presentation

In the opinion of management, the accompanying unaudited condensed interim consolidated financial statements contain all adjustments, all of which are normal and recurring in nature, necessary to fairly state our financial position, results of operations and cash flows. The results of operations for the interim periods presented are not necessarily indicative of the results that may be expected for any future interim periods or for the full fiscal year. These interim financial statements should be read in conjunction with the audited consolidated financial statements in our Annual Report on Form 10-K for the year ended December 31, 2006.

The year-end balance sheet at December 31, 2006 was derived from audited financial statements, but does not include all disclosures required by U.S. generally accepted accounting principles. Please refer to the audited consolidated financial statements in our Annual Report on Form 10-K for the year ended December 31, 2006.

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Other Operating Expenses

Legal, tax, accounting, and other professional services costs associated with our voluntary independent review of our historical stock option granting practices are included as other operating expenses. We incurred $4.0 million in such expenses for the three and six month periods ended June 30, 2007, respectively.

Recent Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board, or FASB, issued Statement on Financial Accounting Standards, *Fair Value Measurements*, or SFAS No. 157. SFAS No. 157 defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles, and expands disclosures about fair value measurements. This statement does not require any new fair value measurements; rather, it applies under other accounting pronouncements that require or permit fair value measurements. The provisions of this statement are to be applied prospectively as of the beginning of the fiscal year in which this statement is initially applied, with any transition adjustment recognized as a cumulative-effect adjustment to the opening balance of retained earnings. The provisions of this statement are to be applied prospectively as of the beginning of the fiscal year in which this statement is initially applied, with any transition adjustment recognized as a cumulative-effect adjustment to the opening balance of retained earnings. SFAS No. 157 is effective for the fiscal years beginning after November 15, 2007. We do not expect a material impact from the adoption of SFAS No. 157 on our financial position and results of operations.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, or SFAS No. 159. The fair value option established by SFAS No. 159 permits, but does not require, all entities to choose to measure eligible items at fair value at specified election dates. An entity would report unrealized gains and losses on items for which the fair value option has

SILICON STORAGE TECHNOLOGY, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

1. Basis of Presentation (Continued)

been elected in earnings at each subsequent reporting date. SFAS No. 159 is effective fiscal years beginning after November 15, 2007. We are currently assessing the impact of the adoption of SFAS No. 159 on our financial position and results of operations.

In December 2007, the FASB issued SFAS No. 141 (Revised 2007), *Business Combinations*, or SFAS No. 141R. SFAS No. 141R will change the accounting for business combinations. Under SFAS No. 141R, an acquiring entity will be required to recognize all the assets acquired and liabilities assumed in a transaction at the acquisition-date fair value with limited exceptions. SFAS No. 141R will change the accounting treatment and disclosure for certain specific items in a business combination. SFAS No. 141R applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. Accordingly, any business combinations we engage in will be recorded and disclosed following existing GAAP until January 1, 2009. We expect SFAS No. 141R will have an impact on accounting for business combinations once adopted but the effect is dependent upon acquisitions at that time. We are still assessing the impact of this pronouncement.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements An Amendment of ARB No. 51*, or SFAS No. 160. SFAS No. 160 establishes new accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. SFAS 160 is effective for fiscal years beginning on or after December 15, 2008. We have not completed our evaluation of the potential impact, if any, of the adoption of SFAS No. 160 on our consolidated financial position, results of operations and cash flows.

2. Restatement of Consolidated Financial Statements

Independent Investigation

In March 2007, the Board of Directors of SST initiated a voluntary review of SST's historical stock option grant practices covering the time from SST's initial public offering in 1995 through 2007. The review was led by the Chairman of the Audit Committee of the Board of Directors with the assistance of outside independent legal counsel, and began on or about March 15, 2007.

The Chairman's review was substantially completed on October 20, 2007 when the Chairman reported his findings to the Board of Directors. The review covered all option grants during the period from SST's initial public offering in November 1995 through 2007. As part of his review, the Chairman determined whether the correct measurement dates had been used under applicable accounting principles for these options. The measurement date is the date on which the related compensation cost for an option is determined under applicable accounting principles, namely Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*, or APB No. 25, and related interpretations, and is the first date on which all of the following are known: (1) the individual employee who is entitled to receive the option grant, (2) the number of options that an individual employee is entitled to receive, and (3) the option's exercise price.

Based on the findings of the Chairman, we identified a number of occasions on which we used an incorrect measurement date for financial accounting and reporting purposes. These errors resulted primarily from our use from 1997 through mid-2002, of certain date selection methods which resulted in grantees receiving options with stated exercise prices lower than the market price of the underlying

SILICON STORAGE TECHNOLOGY, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

2. Restatement of Consolidated Financial Statements (Continued)

stock on the revised measurement dates. We ceased using such practices beginning in mid-2002. The Chairman found that, beginning in mid-2002, we improved our stock option grant processes with respect to new hire and promotion grants and have generally granted and priced our stock options for new hires and promotions in an objective and consistent manner since that time. However, from 1997 through 2005, we used incorrect measurement dates for financial accounting and reporting purposes for company-wide or retention stock option grants and in various other circumstances as discussed in our Annual Report on Form 10-K for the year ended December 31, 2006. The Chairman's review did not identify any additional stock-based compensation charges from measurement date issues subsequent to 2005.

In accordance with APB No. 25 (intrinsic value method), with respect to periods though December 31, 2005, we should have recorded stock-based compensation expense to the extent that the fair market value of our common stock on the correct measurement date exceeded the exercise price of each option granted. For periods commencing January 1, 2006 we record stock-based compensation expense in accordance with Statement of Financial Accounting Standards No. 123(R), *Share-Based Payment*, or SFAS No. 123(R).

For all periods through December 31, 2005, we have recorded aggregate non-cash stock-based compensation charges of $38.8 million, associated payroll tax charges of $4.3 million and a related income tax benefit of $1.0 million. We have amortized a substantial portion of the APB No. 25 charges on a straight line basis to expense during 1997 to 2005. If an option is forfeited prior to vesting, we reverse to income the charges amortized to expense in prior periods to additional paid in capital and reverse any remaining unamortized deferred stock-based compensation associated with the forfeited options. Accordingly, our net stock-based compensation charges amortized to our statement of income are lower than the aggregate stock-based compensation charges determined on the measurement date based on APB No. 25 (intrinsic value method). As of December 31, 2005, the remaining APB No. 25 (intrinsic value method) unamortized deferred stock-based compensation related to the errors identified during the review was approximately $558,000.

We are restating our condensed consolidated statements of operations for the three and six months ended June 30, 2006, our condensed consolidated statements of cash flows for the six months ended June 30, 2006, and related disclosures in this Quarterly Report on Form 10-Q.

Summary of Accounting Adjustments

As part of the restatement of our condensed consolidated financial statements reported in our Annual Report on Form 10-K for the year ended December 31, 2006, we recorded stock-based compensation and other adjustments previously determined to be immaterial for the three and six months ended June 30, 2006. The impact of such adjustments for the three and six month periods ended June 30, 2006 was a decrease in net income of $68,000 and an increase in net income of $578,000, respectively. In addition, we recorded adjustments of $209,000 and $429,000 to net income due to the change in accounting from to equity method in Advanced Chip Engineering Technology Inc. for the three and six months ended June 30, 2006.

The following tables present the effect of the stock-based compensation expense adjustments, other adjustments relating to items previously deemed immaterial, the change in accounting from the cost

SILICON STORAGE TECHNOLOGY, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

2. Restatement of Consolidated Financial Statements (Continued)

method to the equity method to account for our investment in Advanced Chip Engineering Technology, Inc. and related income tax effect on our previously reported condensed consolidated statements of operations and condensed consolidated statement of cash flows:

	Three Months Ended June 30, 2006				
	As previously reported	**Adjustments(1)**	**As Adjusted**	**Adjustments(2)**	**As Adjusted and Restated**
Net revenues:					
Product revenues unrelated parties	$ 40,775	$	$ 40,775	$	$ 40,775
Product revenues related parties	58,163		58,163		58,163
License revenues unrelated parties	8,791		8,791		8,791
Total net revenues	107,729		107,729		107,729
Cost of revenues:					
Cost of revenues unrelated parties	29,259		29,259	(14)	29,245
Cost of revenues related parties	51,096		51,096	(25)	51,071
Total cost of revenues	80,355		80,355	(39)	80,316
Gross profit	27,374		27,374	39	27,413
Operating expenses:					
Research and development	13,093		13,093	148	13,241
Sales and marketing	7,042		7,042	66	7,108
General and administrative	5,769		5,769	44	5,813
Total operating expenses	25,904		25,904	258	26,162
Income from operations	1,470		1,470	(219)	1,251
Interest income	999		999		999
Dividend income	66		66		66
Other income (expense), net	(9)	24	15		15
Interest expense	(57)		(57)	(8)	(65)
Income before provision for (benefit from) income taxes and pro rata share of loss from equity investments	2,469	24	2,493	(227)	2,266
Provision for income taxes	1,014		1,014	(159)	855
Income before pro rata share of loss from equity investments	1,455	24	1,479	(68)	1,411
Pro rata share of loss from equity investments		233	233		233

	Three Months Ended June 30, 2006				
Net income	$ 1,455	$ (209)	$ 1,246	$ (68)	$ 1,178
Net income per share basic	$ 0.01	$	$ 0.01	$	$ 0.01
Shares used in per share calculation basic	103,178		103,178		103,178
Net income per share diluted	$ 0.01	$	$ 0.01	$	$ 0.01
Shares used in per share calculation diluted	104,529		104,529	(132)	104,397

(1) The adjustments reflect the change in accounting methodology from the cost method to the equity method to account for our investment in Advanced Chip Engineering Technology, Inc.

(2) The restated consolidated statement of operations and cash flows the six months ended June 30, 2006 includes stock-based compensation expense (Note 4). As part of the restatement, we also recorded other adjustments that were previously considered to be immaterial.

SILICON STORAGE TECHNOLOGY, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

2. Restatement of Consolidated Financial Statements (Continued)

	Six Months Ended June 30, 2006				
	As previously reported	Adjustments(1)	As Adjusted	Adjustments(2)	As Adjusted and Restated
Net revenues:					
Product revenues unrelated parties	$ 78,807	$	$ 78,807	$	$ 78,807
Product revenues related parties	120,434		120,434		120,434
License revenues unrelated parties	17,641		17,641		17,641
License revenues related parties	1,378		1,378		1,378
Total net revenues	218,260		218,260		218,260
Cost of revenues:					
Cost of revenues unrelated parties	57,074		57,074	74	57,148
Cost of revenues related parties	99,899		99,899	128	100,027
Total cost of revenues	156,973		156,973	202	157,175
Gross profit	61,287		61,287	(202)	61,085
Operating expenses:					
Research and development	28,260		28,260	(125)	28,135
Sales and marketing	15,203		15,203	58	15,261
General and administrative	11,806		11,806	(770)	11,036
Total operating expenses	55,269		55,269	(837)	54,432
Income (loss) from operations	6,018		6,018	635	6,653
Interest income	1,337		1,337		1,337
Dividend income	165		165		165
Other income (expense), net	(7)	48	41		41
Interest expense	(136)		(136)	30	(106)
Gain on sale of equity investments	12,206		12,206		12,206
Impairment of equity investments	(3,523)		(3,523)		(3,523)
Income before provision for (benefit from) income taxes, pro rata share of loss from equity investments and minority interest	16,060	48	16,108	665	16,773
Provision for income taxes	3,315		3,315	(337)	2,978
Income before pro rata share of loss from equity investments	12,745	48	12,793	1,002	13,795
Pro rata share of loss from equity investments		472	472		472
Net income	$ 12,745	$ (424)	$ 12,321	$ 1,002	$ 13,323

	Six Months Ended June 30, 2006				
Net income per share basic	$ 0.12		$ 0.12	$ 0.01	$ 0.13
Shares used in per share calculation basic	103,159		103,159		103,159
Net income per share diluted	$ 0.12		$ 0.12	$ 0.01	$ 0.13
Shares used in per share calculation diluted	104,634		104,634	(166)	104,468

(1) The adjustments reflect the change in accounting methodology from the cost method to the equity method to account for our investment in Advanced Chip Engineering Technology, Inc.

(2) The restated consolidated statement of operations and cash flows the six months ended June 30, 2006 includes stock-based compensation expense (Note 4). As part of the restatement, we also recorded other adjustments that were previously considered to be immaterial.

SILICON STORAGE TECHNOLOGY, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

2. Restatement of Consolidated Financial Statements (Continued)

	Six Months Ended June 30, 2006				
	As previously reported	**Adjustment(1)**	**As adjusted**	**Adjustments(2)**	**As adjusted and restated**
Cash flows from operating activities:					
Net income	$ 12,745	$ (424)	$ 12,321	$ 1,002	$ 13,323
Adjustments to reconcile net income (loss) to net cash used in operating activities:					
Depreciation and amortization	4,982		4,982		4,982
Stock-based compensation expense	3,802		3,802	465	4,267
Provision for doubtful accounts receivable	323		323		323
Provision for sales returns	421		421		421
Provision for excess and obsolete inventories, write-down of inventories and adverse purchase commitments	8,446		8,446	368	8,814
Pro rata share of loss from equity investments	28	444	472		472
Impairment loss on equity investment	3,523		3,523		3,523
Gain on sale of equity investments	(12,206)		(12,206)		(12,206)
Gain on disposal of equipment	(6)		(6)		(6)
Changes in operating assets and liabilities:					
Trade accounts receivable-unrelated parties	(739)		(739)		(739)
Trade accounts receivable-related parties	17,906		17,906		17,906
Inventories	5,017		5,017	(119)	4,898
Other current and non-current assets	(2,681)	(20)	(2,701)		(2,701)
Trade accounts payable-unrelated parties	(15,880)		(15,880)		(15,880)
Trade accounts payable-related parties	(76)		(76)		(76)
Accrued expenses and other liabilities	4,082		4,082	(1,716)	2,366
Deferred revenue	(403)		(403)		(403)
Net cash provided by operating activities	29,284		29,284		29,284

SILICON STORAGE TECHNOLOGY, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

2. Restatement of Consolidated Financial Statements (Continued)

Cash flows from investing activities:			
Investments in equity securities	(3,000)	(3,000)	(3,000)
Purchase of property and equipment	(2,359)	(2,359)	(2,359)
Proceeds from sale of equipment	9	9	9
Purchase of intellectual property license	(317)	(317)	(317)
Purchases of available-for-sale investments	(33,699)	(33,699)	(33,699)
Sales and maturities of available-for-sale and equity investments	19,820	19,820	19,820
Net cash used in investing activities	(19,546)	(19,546)	(19,546)
Cash flows from financing activities:			
Debt repayments	(94)	(94)	(94)
Issuance of shares of common stock	1,374	1,374	1,374
Principal payments of capital leases	(602)	(602)	(602)
Net cash provided by financing activities	678	678	678
Net increase in cash and cash equivalents	10,416	10,416	10,416
Cash and cash equivalents at beginning of period	77,382	77,382	77,382
Cash and cash equivalents at end of period	$ 87,798	$ 87,798	$ 87,798

(1) The adjustments reflect the change in accounting methodology from the cost method to the equity method to account for our investment in Advanced Chip Engineering Technology, Inc.

(2) The adjustments reflect additional stock-based compensation recorded in connection with this restatement to correct prior year stock option-related accounting errors, and related tax impacts, and to reflect the impact of other adjustments that were previously considered to be immaterial.

SILICON STORAGE TECHNOLOGY, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

3. Computation of Net Income (Loss) Per Share

We have computed and presented net income (loss) per share under two methods, basic and diluted. Basic net income (loss) per share is computed by dividing net income (loss) by the weighted average number of common shares outstanding for the period. Diluted net income (loss) per share is computed by dividing net income (loss) by the sum of the weighted average number of common shares outstanding and potential common shares (when dilutive). A reconciliation of the numerator and the denominator of basic and diluted net income (loss) per share is as follows (in thousands, except per share amounts):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2007	2006	2007
	(As Adjusted and Restated)		(As Adjusted and Restated)	
Numerator basic				
Net income (loss)	$ 1,178	$ (7,519)	$ 13,323	$ (8,833)
Denominator basic				
Weighted average common stock outstanding	103,178	104,198	103,159	104,071
Basic net income (loss) per share	$ 0.01	$ (0.07)	$ 0.13	$ (0.08)
Denominator diluted				
Weighted average common stock outstanding	103,178	104,198	103,159	104,071
Dilutive potential of common stock equivalents	1,219		1,309	
Options	104,397	104,198	104,468	104,071
Diluted net income (loss) per share	$ 0.01	$ (0.07)	$ 0.13	$ (0.08)

Stock options to purchase 11,911,039 shares of common stock were outstanding with a weighted average exercise price of $6.73 for both three and six months ended June 30, 2007. These stock options were not included in the computation of diluted net loss per share for both three and six months ended June 30, 2007 because we had net losses for these periods. Stock options to purchase 8,450,580 and 8,492,481 shares with weighted average per share prices of $9.09 and $9.10, respectively, were outstanding and not included in the computation of diluted net income per share for the three and six months ended June 30, 2006, respectively, as they were anti-dilutive under the treasury stock method.

4. Stock Compensation

Employee Stock Purchase Plan

Our 1995 Employee Stock Purchase Plan, or the Purchase Plan, as amended, has 6.0 million shares of common stock reserved for issuance. The Purchase Plan provides for eligible employees to purchase shares of common stock at a price equal to 90% of the fair value of our common stock six months after the option date by withholding up to 10% of their annual base earnings. As of June 30, 2007, 486,000 shares were available for purchase under the Purchase Plan. Shares issued under the Purchase Plan for the six months ended June 30, 2007 were 155,000.

SILICON STORAGE TECHNOLOGY, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

4. Stock Compensation (Continued)

Equity Incentive Plan

Our 1995 Equity Incentive Plan, or the Equity Incentive Plan, as amended, has 31.8 million shares of common stock reserved for issuance upon the exercise of stock options to our employees, directors, consultants and affiliates. Under the Equity Incentive Plan, the Board of Directors has the authority to determine to whom options will be granted, the number of shares under option, the option term and the exercise price. The options generally are exercisable beginning one year from the date of grant and generally thereafter over periods ranging from four to five years from the date of grant. The term of any options issued may not exceed ten years from the date of grant.

Directors' Stock Option Plan

Each of our non-employee directors receives stock option grants under our 1995 Non-Employee Directors' Stock Option Plan, or the Directors' Plan, as amended. Pursuant to the Directors' Plan, upon each non-employee director's initial election or appointment to the Board, such new non-employee director receives an initial stock option grant for 45,000 shares of common stock. Each initial stock option grant vests as to 25% of the shares subject to the grant on the anniversary of the grant date. In addition, each non-employee director receives a fully vested annual stock option grant for 12,000 shares of common stock. As of June 30, 2007, the Directors' Plan had 169,000 shares available for issuance.

Compensation Expense

We recognize stock-based compensation on the graded vesting method over the vesting periods of the stock options, generally four years. The graded vesting method provides for vesting of portions of the overall awards at interim dates and results in accelerated vesting as compared to the straight-line method.

The amount of recognized compensation expense for our stock option plans is adjusted based upon an estimated forfeiture rate which is derived from historical data.

The Purchase Plan provides for eligible employees to purchase shares of common stock at a price equal to 90% of the fair value of our common stock on the last day of each six-month offering period. The compensation is the difference between the fair value and purchase price on the date of purchase.

SILICON STORAGE TECHNOLOGY, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

4. Stock Compensation (Continued)

The following table shows total stock-based compensation expense included in the condensed consolidated statement of operations (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2007	2006	2007
	As Restated		As Restated	
Cost of goods sold	$ 114	$ 160	$ 246	$ 298
Research and development	938	741	1,989	1,525
Sales and marketing	304	268	621	543
General and administrative	625	329	1,293	713
Effect on pre-tax income	1,981	1,498	4,149	3,079
Tax effect of stock-based compensation expense				
Effect on net income	$ 1,981	$ 1,498	$ 4,149	$ 3,079

Stock-based compensation of $124,000 and $164,000 was capitalized in inventory as of June 30, 2007 and December 31, 2006, respectively. The tax benefit from the exercise of options was $0 for the three and six months ended June 30, 2006 and 2007, respectively.

Stock Option Plans

Pursuant to our Equity Incentive Plan and Director's Plan, stock options are granted with an exercise price equal to the market price of our common stock at the date of grant. Substantially all of the options granted to employees are exercisable pursuant to a four-year vesting schedule with a maximum contractual term of ten years. The fair value of these options is estimated using the Black-Scholes option pricing model which incorporates the assumptions noted in the table below. The risk-free interest rate for periods within the expected life of the option is based on the U.S. Treasury bond rate in effect at the time of grant. We do not pay dividends and do not expect to do so in the future. Expected volatilities are based on the historical performance of our common stock. The expected term of the options granted is 6.0 years calculated using the simplified method allowed under Staff Accounting Bulletin No. 107.

The fair values of grants in the stated period were computed using the following assumptions for our stock option plans:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2007	2006	2007
Risk-free interest rate	4.8%	4.5%	4.3%-4.8%	4.5%-4.7%
Dividend yield	0.0%	0.0%	0.0%	0.0%
Expected volatility	82.6%	70.8%	77.0%-82.6%	70.8%-73.4%
Expected life	6.0 years	6.0 years	6.0 years	6.0 years

SILICON STORAGE TECHNOLOGY, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

4. Stock Compensation (Continued)

The following is a summary of all option activity for the six months ended June 30, 2007 (options in thousands):

	Shares Available for Grant	Number of Shares Outstanding	Weighted Average Price	Weighted Average Remaining Term (in years)	Aggregate Intrinsic Value as of
Outstanding at December 31, 2006	2,436	12,096	$ 6.68	6.04	$ 7,463
Granted	(250)	250	$ 5.07		
Exercised		(414)	$ 1.31		
Forfeited	157	(157)	$ 4.60		
Expired	168	(168)	$ 10.24		
Outstanding at March 31, 2007	2,511	11,607	$ 6.82	6.03	$ 8,298
Granted	(462)	462	$ 3.89		
Exercised			$		
Forfeited	123	(123)	$ 4.96		
Expired	35	(35)	$ 4.61		
Outstanding at June 30, 2007	2,207	11,911	$ 6.73	5.91	$ 3,491
Vested and Expected to Vest at June 30, 2007		11,651	$ 6.78	4.87	$ 3,480
Options Exercisable at June 30, 2007		7,588	$ 7.80	4.36	$ 3,266

A summary of our stock options outstanding at June 30, 2007 as follows (options in thousands):

		Options Outstanding			Options Exercisable	
Range of Exercise Prices		Number Outstanding	Weighted-Average Remaining Life	Weighted-Average Exercise Price	Number Outstanding	Weighted-Average Exercise Price
$ 0.44	$ 2.36	1,304	1.26	$ 1.52	1,304	$ 1.52
$ 2.54	$ 3.65	1,523	6.94	$ 3.33	867	$ 3.29
$ 3.72	$ 4.42	1,863	8.78	$ 4.14	283	$ 4.11
$ 4.46	$ 4.90	1,602	6.85	$ 4.69	764	$ 4.56
$ 4.93	$ 6.48	1,656	7.04	$ 5.62	830	$ 5.67
$ 6.66	$ 8.63	1,238	6.23	$ 7.74	896	$ 7.85
$ 8.75	$ 11.20	1,208	5.04	$ 9.75	1,183	$ 9.74
$ 11.81	$ 21.04	1,196	3.74	$ 15.92	1,140	$ 16.03
$ 22.04	$ 28.35	316	2.98	$ 25.27	316	$ 25.27
$ 29.44	$ 29.44	5	3.00	$ 29.44	5	$ 29.44
$ 0.44	$ 29.44	11,911	5.91	$ 6.73	7,588	$ 7.80

Options Outstanding	Options Exercisable

We settle stock option exercises with newly issued shares of common stock. We do not have any equity instruments outstanding other than the stock options described above as of June 30, 2007.

SILICON STORAGE TECHNOLOGY, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

5. Investments

We consider cash and all highly liquid investments purchased with an original or remaining maturity of less than three months at the date of purchase to be cash equivalents. Substantially all of our cash and cash equivalents are in the custody of three major financial institutions.

Short and long-term investments, which are comprised of federal, state and municipal government obligations, foreign and public corporate debt securities and marketable equity securities, are classified as available-for-sale and carried at fair value, based on quoted market prices, with the unrealized gains or losses, net of tax, reported in shareholders' equity as other comprehensive income. The cost of debt securities is adjusted for amortization of premiums and accretion of discounts to maturity, both of which are included in interest income. Realized gains and losses are recorded on the specific identification method.

In the three months ended March 31, 2006, we sold 4.0 million common shares of our investment in Powertech Technology, Incorporated, or PTI, for a pre-tax gain of approximately $12.2 million. We continue to own approximately 6.3 million shares of PTI at June 30, 2007.

Investments in privately held enterprises and certain restricted stocks are accounted for using either the cost or equity method of accounting, as appropriate. Each period, we evaluate whether an event or change in circumstances had occurred that may indicate an investment has been impaired. If upon further investigation of such events we determine the investment has suffered a decline in value that is other than temporary, we write down the investment to its estimated fair value. As of June 30, 2007 and December 31, 2006 the carrying value of these investments was $65.2 million and $67.8 million, respectively.

King Yuan Electronics Company Limited, or KYE, Insyde Software Corporation, or Insyde, PTI and Professional Computer Technology Limited, or PCT, are Taiwanese companies that are listed on the Taiwan Stock Exchange. Equity investments in these companies have been included in "Long-term available-for-sale investments." The investments that are not available for resale due to local securities regulations within one year at the balance sheet date are recorded at the investment cost. The investments that are available for resale within one year at the balance sheet date are recorded at fair market value, with unrealized gains and losses, net of tax, reported in shareholders' equity as other comprehensive income. If a decline in value is judged to be other than temporary, it is reported as an impairment of equity investments. Cash dividends and other distributions of earnings from the investees, if any, are included in other income when declared.

In September 2006, we invested an additional $15.9 million in Advanced Chip Engineering Technology Inc., or ACET, that increased our ownership share of ACET's outstanding capital stock from 9.4% to 46.9% and required us to change from the cost method of accounting to the equity method of accounting for this investment. Under the equity method of accounting, we are required to record our ownership interest in ACET's reported net income or loss each reporting period as well as restate our prior period financial statements to reflect the equity method of accounting from the date of the initial investment. Our operating results now include a line item titled "pro rata share of loss from equity investments" on our condensed consolidated statement of operations where we record these expenses. For the quarter ended June 30, 2007, our pro rata share of the loss in ACET was $1.9 million, compared to $233 thousand for the same period in the prior year. In the third quarter we made an additional cash investment, along other third-party investors, of $10.3 million in ACET's common stock. Our total investment represents 38.5% of the outstanding equity of ACET at

SILICON STORAGE TECHNOLOGY, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

5. Investments (Continued)

September 30, 2007. We recorded a $1.8 million gain in connection with the transaction reflecting the change in our ownership interest in the underlying net assets of ACET. The gain was recorded to Additional Paid in Capital.

Noted in the table below is unaudited summarized information regarding ACET's results of operation without any pro-rata adjustments for our investment in the outstanding equity of ACET (thousands):

	For the three months ended June 30,		For the six months ended June 30,	
	2006	**2007**	**2006**	**2007**
Net sales	$ 140	$ 299	$ 386	$ 445
Gross loss	$ (1,502)	$ (2,223)	$ (2,992)	$ (4,305)
Net loss	$ (2,224)	$ (3,400)	$ (4,513)	$ (6,467)

We owned 9.8% of the equity of Grace Semiconductor Manufacturing Corporation, or GSMC, as of June 30, 2007 with a carrying value of $42.6 million. In the third quarter ended September 30, 2007, we determined our investment in GSMC had experienced a decline in value based on an independent third party valuation of our investment in GSMC. Accordingly, we recorded a charge for the quarter ended September 30, 2007 of $19.4 million.

In the three months ended March 31, 2006, we determined our investment in Nanotech Corporation, or Nanotech, a privately held Cayman Island company, had become impaired as Nanotech defaulted on loan payments to certain of its business partners and began the process of discontinuing operations. Consequently, our remaining investment of $3.3 million along with a loan of $225,000 were written off.

The fair values of available-for-sale investments as of June 30, 2007 were as follows (in thousands):

	Amortized Cost	**Unrealized Gain**	**Unrealized Loss**	**Fair Value**
Corporate bonds and notes	$ 33,549	$	$ (28)	$ 33,521
Government bonds and notes	48,171		(33)	48,138
Foreign listed equity securities	4,881	33,285		38,166
Total bonds, notes and equity securities	$ 86,601	$ 33,285	$ (61)	$ 119,825
Less amounts classified as cash equivalents				(18,545)
Total short and long-term available-for-sale investments				$ 101,280

Contractual maturity dates of our available-for-sale investments for debt securities generally occur all in the current year. All of these securities are classified as current as they are expected to be realized in cash or sold or consumed during the normal operating cycle of our business.

The unrealized gains and losses as of June 30, 2007 are recorded in accumulated other comprehensive income, net of tax.

SILICON STORAGE TECHNOLOGY, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

5. Investments (Continued)

The fair values of available-for-sale investments as of December 31, 2006 were as follows (in thousands):

	Amortized Cost	Unrealized Gain	Unrealized Loss	Fair Value
Corporate bonds and notes	$ 28,279	$	$ (9)	$ 28,270
Government bonds and notes	51,422		(6)	51,416
Foreign listed equity securities	6,482	31,181		37,663
Total bonds, notes and equity securities	$ 86,183	$ 31,181	$ (15)	$ 117,349
Less amounts classified as cash equivalents				(32,960)
Total short and long-term available-for-sale investments				$ 84,389
Contractual maturity dates for investments in bonds and notes:				
Less than one year				71,795
One to five years				7,891
				$ 79,686

The unrealized gains and losses as of December 31, 2006 are recorded in accumulated other comprehensive income, net of tax.

We compare the carrying value of our available for sale investments with their quoted market prices at the end of each period. If the quoted market price of a marketable security has dropped significantly during a period or has been below our carrying value for an extended period of time, we review the investment to determine whether the decline is other than temporary. In making this determination, we consider among other things, the investee's recent operating performance, cash position and revenue and earnings outlook. If we determine that the decline is other than temporary, the investment is written down to its market value as measured at the end of the period. Any resulting charge is included in our statement of operations in the related period. Future increases in the quoted market value of the investment are not recognized until the underlying securities are sold.

6. Selected Balance Sheet Detail

Details of selected balance sheet accounts are as follows (in thousands):

Inventories comprise:

	December 31, 2006	June 30, 2007
Raw materials	$ 53,683	$ 28,703
Work in process	3,307	12,078
Finished goods	10,951	6,844
Finished goods inventories held at logistics center	5,942	5,806
	$ 73,883	$ 53,431

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SILICON STORAGE TECHNOLOGY, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

6. Selected Balance Sheet Detail (Continued)

Inventories are stated at the lower of cost, determined on a first-in, first-out basis, or market value. We typically plan our production and inventory levels based on internal forecasts of customer demand, which are highly unpredictable and can fluctuate substantially. The value of our inventory is dependent on our estimate of future average selling prices, and, if our projected average selling prices are over estimated, we may be required to adjust our inventory value. If we over estimate future market demand, we may end up with excess inventory levels that cannot be sold within a normal operating cycle and we may be required to record a provision for excess inventory. Our inventories include high technology parts and components that are specialized in nature or subject to rapid technological obsolescence. Some of our customers have requested that we ship them product that has a finished goods date of manufacture less than one year. In the event that this becomes a common requirement, it may be necessary for us to provide for an additional allowance for our on-hand finished goods inventory with a date of manufacture of greater than one year, which could result in a material adjustment and could harm our financial results. We review on-hand inventory including inventory held at the logistic center for potential excess, obsolescence and lower of cost or market exposure and record provisions accordingly. Due to the large number of units in our inventory, even a small change in average selling prices could result in a significant adjustment and have a material impact on our financial position and results of operations.

Our allowance for excess and obsolete inventories includes a provision for finished goods inventory with a date of manufacture of greater than two years and for certain products with a date of manufacture of greater than one year. In addition, our allowance includes an allowance for die, work-in-process and finished goods inventories that exceed our estimated forecast for the next twelve to twenty four months. For the obsolete inventory analysis, we review inventory items in detail and consider date code, customer base requirements, known product defects, planned or recent product revisions, end of life plans and diminished market demand. For excess inventory analysis, we review inventory items in detail and consider our customer base requirements and market demand. While we have programs to minimize inventories on hand and we consider technological obsolescence when estimating allowances for potentially excess and obsolete inventories and those required to reduce recorded amounts to market values, it is reasonably possible that such estimates could change in the near term. Such changes in estimates could have a material impact on our financial position and results of operations.

Accrued expenses and other liabilities comprise (in thousands):

	December 31, 2006	June 30, 2007
Accrued compensation and related items	$ 9,774	$ 10,377
Accrued adverse purchase commitments	119	15
Accrued commission	2,004	2,140
Accrued income tax payable	5,644	(766)
Accrued warranty	298	371
Other accrued liabilities	6,276	6,694
	$ 24,115	$ 18,831

SILICON STORAGE TECHNOLOGY, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

6. Selected Balance Sheet Detail (Continued)

Changes in the warranty reserves during the six months ended June 30, 2006 and 2007 were as follows (in thousands):

	Six Months Ended June 30,	
	2006	2007
Beginning balance	$ 803	$ 298
Provisions for warranty	1,736	1,385
Consumption of reserves	(1,629)	(1,312)
Ending balance	$ 910	$ 371

Our products are generally subject to warranty and we provide for the estimated future costs of repair, replacement or customer accommodation upon shipment of the product in our condensed consolidated statements of operations. Our warranty accrual is estimated based on historical claims compared to historical revenues. For new products, we use our historical percentage for the appropriate class of product.

7. Commitments

Our technology license agreements generally include an indemnification clause that indemnifies the licensee against liability and damages (including legal defense costs) arising from any claims of patent, copyright, trademark or trade secret infringement by our proprietary technology. The terms of these guarantees approximate the terms of the technology license agreements, which typically range from five to ten years. Our current license agreements expire from 2007 through 2014. The maximum possible amount of future payments we could be required to make, if such indemnifications were required on all of these agreements, is $46.0 million. We have not recorded any liabilities as of June 30, 2007 related to these indemnities as no such claims have been made or asserted.

During our normal course of business, we have made certain indemnities, commitments and guarantees under which we may be required to make payments in relation to certain transactions. These include indemnities to various lessors in connection with facility leases for certain claims arising from such facility or lease and indemnities to our directors and officers to the maximum extent permitted under the laws of California. In addition, we have contractual commitments to some customers, which could require us to incur costs to repair an epidemic defect with respect to our products outside the normal warranty period if such defect were to occur. The duration of these indemnities, commitments and guarantees varies. The majority of these indemnities, commitments and guarantees do not provide for any limitation of the maximum potential future payments that we could be obligated to make. We have not recorded any liability for these indemnities, commitments and guarantees in the accompanying condensed consolidated balance sheets. We do, however, accrue for losses for any known contingent liability, including those that may arise from indemnification provisions, when future payment is probable and the amount is reasonably estimatable.

8. Contingencies

In January and February 2005, multiple putative shareholder class action complaints were filed against SST and certain directors and officers alleging insider trading and manipulation of stock prices,

SILICON STORAGE TECHNOLOGY, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

8. Contingencies (Continued)

in the United States District Court for the Northern District of California, following our announcement of anticipated financial results for the fourth quarter of 2004. On March 24, 2005, the putative class actions were consolidated under the caption *In re Silicon Storage Technology, Inc., Securities Litigation*, Case No. C 05 00295 PJH (N.D. Cal.). On May 3, 2005, the Honorable Phyllis J. Hamilton appointed the "Louisiana Funds Group," consisting of the Louisiana School Employees' Retirement System and the Louisiana District Attorneys' Retirement System, to serve as lead plaintiff and the law firms of Pomeranz Haudek Block Grossman & Gross LLP and Berman DeValerio Pease Tabacco Burt & Pucillo to serve as lead counsel and liaison counsel, respectively, for the class. Lead plaintiff filed a Consolidated Amended Class Action Complaint on July 15, 2005, which the Court dismissed with leave to amend on March 10, 2006. Plaintiff filed a second amended complaint on May 1, 2006, again seeking unspecified damages for alleged violations of federal securities laws during the period from April 21, 2004 to December 20, 2004. We responded with a motion to dismiss on June 19, 2006. On March 9, 2007, the Court issued an Order granting our motion to dismiss, *with prejudice*, and on March 12, 2007 entered a judgment that plaintiffs take nothing and the action be dismissed on the merits. Lead plaintiff filed a notice of appeal but did not follow through and by stipulation, the suit was dismissed.

In January and February 2005, following the filing of the putative class actions, multiple shareholder derivative complaints were filed in California Superior Court for the County of Santa Clara, purportedly on behalf of SST against certain of our directors and officers. The factual allegations of these complaints were substantially identical to those contained in the putative shareholder class actions filed in federal court. The derivative complaints asserted claims for, among other things, breach of fiduciary duty and violations of the California Corporations Code. These derivative actions were consolidated under the caption *In Re Silicon Storage Technology, Inc. Derivative Litigation,* Lead Case No. 1:05CV034387 (Cal. Super. Ct., Santa Clara Co.). On April 28, 2005, the derivative action was stayed by court order. On October 19, 2007, following the dismissal with prejudice of the putative class actions, the court lifted this stay. On December 6, 2007, plaintiffs filed a consolidated amended complaint reiterating some of the previous claims and asserting claims substantially identical to those contained in the *Chuzhoy v. Yeh* (Cal. Super. Ct., Santa Clara Co.) and *In re Silicon Storage Technology, Inc., Derivative Litigation* (N.D. Cal., San Jose Div.) putative derivative actions. We intend to continue to take all appropriate actions in response to this lawsuit. The impact related to the outcome of this matter is undeterminable at this time.

On July 13, 2006, a shareholder derivative complaint was filed in the United States District Court for the Northern District of California by Mike Brien under the caption *Brien v. Yeh, et al*., Case No. C06-04310 JF (N.D. Cal.). On July 18, 2006, a shareholder derivative complaint was filed in the United States District Court for the Northern District of California by Behrad Bazargani under the caption *Bazargani v. Yeh, et al*., Case No. C06-04388 HRL (N.D. Cal.). Both complaints were brought purportedly on behalf of SST against certain of our current directors and certain of our current and former officers and allege among other things, that the named officers and directors: (a) breached their fiduciary duties as they colluded with each other to backdate stock options, (b) violated Rule 10b-5 of the Securities Exchange Act of 1934 through their alleged actions, and (c) were unjustly enriched by their receipt and retention of such stock options. The *Brien* and *Bazargani* cases were consolidated into one case: *In re Silicon Storage Technology, Inc. Derivative Litigation*, Case No. C06-04310 JF and a consolidated amended shareholder derivative complaint was filed on October 30, 2006. On April 13,

SILICON STORAGE TECHNOLOGY, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

8. Contingencies (Continued)

2007, the court granted the parties' stipulation staying this action until after we publicly announce the results of the investigation into our historical stock option grant practices, at which time plaintiff shall have 21 days to file a second amended consolidated complaint. On October 31, 2006, a similar shareholder derivative complaint was filed in the Superior Court of the State of California for the County of Santa Clara by Alex Chuzhoy under the caption *Chuzhoy v. Yeh, et al.,* Case No. 1-06-CV-074026. This complaint was brought purportedly on behalf of SST against certain of our current directors and certain of our current and former officers and alleges, among other things, that the named officers and directors breached their fiduciary duties as they colluded with each other to backdate stock options and were allegedly unjustly enriched by their actions. The *Chuzhoy* complaint also alleges that certain of our officers and directors violated section 25402 of the California Corporations Code by selling shares of our common stock while in possession of material non-public adverse information. On April 13, 2007, the court granted the parties' stipulation staying this action until after we publicly announce the results of the investigation into historical stock option grant practices, at which time plaintiff shall have 21 days to file an amended complaint. We intend to take all appropriate action in responding to all of the complaints.

On or about July 13, 2007, a patent infringement suit was brought by OPTi Inc. in the United States District Court for the Eastern District of Texas alleging infringement of two United State patents related to a "Compact ISA-bus Interface". The plaintiff seeks a permanent injunction, and damages for alleged past infringement, as well as any other relief the court may grant that is just and proper. At this time, discovery has not yet commenced, and we intend to vigorously defend the suit.

From time to time, we are also involved in other legal actions arising in the ordinary course of business. We have accrued certain costs associated with defending these matters. There can be no assurance that the shareholder class action complaints, the shareholder derivative complaints or other third party assertions will be resolved without costly litigation, in a manner that is not adverse to our financial position, results of operations or cash flows or without requiring payments in the future which may adversely impact net income. No estimate can be made of the possible loss or possible range of loss associated with the resolution of these contingencies. As a result, no losses associated with these or other litigation have been accrued in our financial statements as of September 30, 2007.

9. Line of Credit

On August 11, 2006, we entered into a 1-year loan and security agreement with Cathay Bank, a U.S. bank, for a $40.0 million revolving line of credit all of which was available to us as of December 31, 2006. The loan agreement was amended in August 2007 to mature in October 2007 as well as waive covenants, which we were in violation of, requiring us to file timely SEC documents Form 10-K for December 31, 2006 as well as Forms 10-Q for the quarters ending March 31, 2007, June 30, 2007 and September 30, 2007. We did not renew this line after its expiration. The line of credit was intended to be used for working capital but there are no restrictions in the agreement as to how the funds may be used. The interest rate for the line of credit is 1% below the prime rate reported from time to time by the Wall Street Journal, Western Edition (8.25% at June 30, 2007). The line of credit is collateralized by substantially all of our assets other than intellectual property. The agreement contains certain financial covenants, including the levels of qualifying accounts receivable and inventories, which could limit the availability of funds under the agreement. As of June 30, 2007, a

SILICON STORAGE TECHNOLOGY, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

9. Line of Credit (Continued)

standby letter of credit in the amount of $8.0 million has been issued against the line as collateral for a line of credit with Bank of America in China. We were not in compliance with certain covenants requiring the timely filing of U.S. GAAP financial statements as of June 30, 2007.

On September 15, 2006, SST China Limited, a wholly-owned subsidiary of SST, entered into a 10-month facility agreement with Bank of America, N.A. Shanghai Branch, a U.S. bank, for RMB 60.8 million revolving line of credit, or approximately $8 million US dollars. This line expired and was replaced on August 07, 2007, when SST China Limited entered into a one year facility agreement with Bank of America, N.A. Shanghai Branch for RMB 58.4 million revolving line of credit. The line of credit will be used for working capital but there are no restrictions in the agreement as to how the funds may be used. The interest rate for the line of credit is 90% of People's Bank of China's base rate (5.72% at June 30, 2007). This facility line is guaranteed by the parent company, Silicon Storage Technology, Inc. SST is required to meet certain financial covenants, including have a ratio of the funded debt to EBITA less than 2.0. If not, SST has to deposit with Bank of America cash collateral at all times in an amount equal to the outstanding principal balance. As of September 30, 2007, SST China Limited has drawn RMB 32 million at the interest rate of 5.427%. We were in compliance with all terms of this facility agreement at September 30, 2007.

10. Goodwill and Intangible Assets:

Our goodwill and intangible assets include $16.5 million of finite-lived intangible assets from acquisitions made in prior years and $2.4 million of purchased intellectual property. Certain of our acquisitions also included in the aggregate of $29.2 million of goodwill. The goodwill is not being amortized but is tested for impairment annually, as well as when an event or circumstance occurs indicating a possible impairment in value.

As of June 30, 2007, our intangible assets consisted of the following (in thousands):

	Cost	Accumulated Amortization	Net
Existing technology	$ 11,791	$ 6,705	$ 5,086
Intellectual property	2,435	79	2,356
Trade name	1,198	672	526
Customer relationships	1,857	1,276	581
Backlog	811	811	
Non-Compete Agreements	810	521	289
	$ 18,902	$ 10,064	$ 8,838

SILICON STORAGE TECHNOLOGY, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

10. Goodwill and Intangible Assets: (Continued)

As of December 31, 2006, our intangible assets consisted of the following (in thousands):

	Cost	Accumulated Amortization	Net
Existing technology	$ 11,791	$ 5,413	$ 6,378
Intellectual property	1,693		1,693
Trade name	1,198	552	646
Customer relationships	1,857	1,027	830
Backlog	811	811	
Non-Compete Agreements	810	417	393
	$ 18,160	$ 8,220	$ 9,940

All intangible assets are being amortized on a straight-line basis over their estimated useful lives. Existing technologies have been assigned useful lives of between four and five years, with a weighted average life of approximately 4.6 years. Non-compete agreements have been assigned useful lives between two and four years, with a weighted average of 3.6 years. Intellectual property has been assigned an estimated life of three to five years and is amortized when it is put into service. Trade names and backlogs have been assigned useful lives of five years, and one year, respectively. Customer relationships have been assigned useful lives between three and five years with a weighted average of 4.0 years. Amortization expense for intangible assets for the six months ended June 30, 2007 was $1.8 million.

Estimated future intangible asset amortization expense for the next five years is as follows (in thousands):

Fiscal Year	Amortization of Intangible Assets
2007 remaining six months	1,800
2008	3,795
2009	2,502
2010	676
2011 and thereafter	65
	$ 8,838

There was no change in the carrying amount of goodwill for the six months ended June 30, 2007 from December 31, 2006.

11. Segment Reporting

Our objective is to transform SST from a pure play in flash memory to become a multi-product line semiconductor company and a leading licensor of embedded flash technology. As a result, the operating results that our chief operating decision maker reviews to make decisions about resource allocations and to assess performance have changed.

SILICON STORAGE TECHNOLOGY, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

11. Segment Reporting (Continued)

Our Memory Product segment, which is comprised of NOR flash memory products, includes the Multi-Purpose Flash, or MPF, family, the Multi-Purpose Flash Plus, or MPF+, family, the Concurrent SuperFlash, or CSF, family, the Firmware Hub, or FWH, family, the Serial Flash family, the ComboMemory family, the Many-Time Programmable, or MTP, family, and the Small Sector Flash, or SSF, family.

Our Non-Memory Products segment includes other semiconductor products including flash microcontrollers, smartcard ICs and modules, radio frequency ICs and modules, NAND controllers and NAND controller based modules.

Technology Licensing includes both license fees and royalties generated from the licensing of our SuperFlash technology to semiconductor manufacturers for use in embedded flash applications.

We do not allocate operating expenses, interest and other income/expense, interest expense, impairment of equity investments or provision for or benefit from income taxes to any of these segments for internal reporting purposes, as we do not believe that allocating these expenses are material in evaluating segment performance.

The following table shows our revenues and gross profit for each segment (in thousands):

	Three Months Ended June 30, 2006		Three Months Ended June 30, 2007	
	Revenues	Gross Profit	Revenues	Gross Profit
	As Restated			
Memory	$ 82,970	$ 14,074	$ 81,299	$ 14,789
Non-Memory	15,968	4,548	8,978	1,738
Technology Licensing	8,791	8,791	9,066	9,066
	$ 107,729	$ 27,413	$ 99,343	$ 25,593

	Six Months Ended June 30, 2006		Six Months Ended June 30, 2007	
	Revenues	Gross Profit	Revenues	Gross Profit
	As Restated			
Memory	$ 163,008	$ 31,792	$ 159,915	$ 29,852
Non-Memory	36,233	10,274	18,573	3,883
Technology Licensing	19,019	19,019	18,379	18,379
	$ 218,260	$ 61,085	$ 196,867	$ 52,114

SILICON STORAGE TECHNOLOGY, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

12. Related Party Transactions and Balances

The following table is a summary of our related party revenues and purchases for the three and six months ended June 30, 2006 and 2007, and our related party accounts receivable and accounts payable and accruals as of December 31, 2006 and June 30, 2007 (in thousands):

	Three Months Ended			
	Revenues		Purchases	
	June 30,		June 30,	
	2006	2007	2006	2007
Silicon Technology Co., Ltd	$ 260	$ 15	$	$
Apacer Technology, Inc. & related entities	714	610		
Silicon Professional Technology Ltd	57,189	54,098		
Grace Semiconductor Manufacturing Corp		31	14,319	16,222
King Yuan Electronics Company, Limited			7,029	4,652
Powertech Technology, Incorporated			3,113	4,540
	$ 58,163	$ 54,754	$ 24,461	$ 25,414

	Six Months Ended			
	Revenues		Purchases	
	June 30,		June 30,	
	2006	2007	2006	2007
Silicon Technology Co., Ltd	$ 486	$ 280	$	$
Apacer Technology, Inc. & related entities	1,680	1,375		
Silicon Professional Technology Ltd	118,268	102,146		
Grace Semiconductor Manufacturing Corp	1,378	121	24,142	32,094
King Yuan Electronics Company, Limited			15,033	12,175
Powertech Technology, Incorporated			6,904	8,991
	$ 121,812	$ 103,922	$ 46,079	$ 53,260

	Trade Accounts Receivable		Account Payable and Accruals	
	December 31, 2006	June 30, 2007	December 31, 2006	June 30, 2007
Silicon Technology Co., Ltd	$ 136	$	$	$ 17
Apacer Technology, Inc. & related entities	570	30		
Advanced Chip Engineering Technology Inc			84	84
Professional Computer Technology Limited			59	43
Silicon Professional Technology Ltd	44,750	32,069	686	510
Grace Semiconductor Manufacturing Corp	105		17,955	13,034

	Trade Accounts Receivable		Account Payable and Accruals	
King Yuan Electronics Company, Limited			10,421	4,894
Powertech Technology, Incorporated			7,305	4,343
	$ 45,561	$ 32,099	$ 36,510	$ 22,925

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SILICON STORAGE TECHNOLOGY, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

12. Related Party Transactions and Balances (Continued)

Professional Computer Technology Limited, or PCT, earns commissions for point-of-sales transactions to customers. PCT's commissions are paid at the same rate as all of our other stocking representatives in Asia. In addition, we pay Silicon Professional Technology Ltd., or SPT, a wholly-owned subsidiary of PCT, a fee for providing logistics center functions. This fee is based on a percentage of revenue for each product shipped through SPT to our end customers. The fee paid to SPT covers the costs of warehousing and insuring inventory and processing accounts receivable, the personnel costs required to maintain logistics and information technology functions and the costs to perform demand forecasting, billing and collection of accounts receivable.

13. Income Taxes

We maintained a full valuation allowance on our net deferred tax assets as of June 30, 2007. The valuation allowance was determined in accordance with the provisions of Statement of Financial Accounting Standards No. 109, or SFAS No. 109, *Accounting for Income Taxes,* which requires an assessment of both positive and negative evidence when determining whether it is more likely than not that deferred tax assets are recoverable; such assessment is required on a jurisdiction by jurisdiction basis. Expected future U.S. losses represented sufficient negative evidence under SFAS No. 109 and accordingly, a full valuation allowance was recorded against U.S. deferred tax assets. We intend to maintain a full valuation allowance on the U.S. deferred tax assets until sufficient positive evidence exists to support reversal of the valuation allowance.

We adopted the provisions of FASB Interpretation Number 48, *Accounting for Uncertainty in Income Taxes,* or FIN No. 48, on January 1, 2007. The cumulative effect of adopting FIN No. 48 was a $3.2 million decrease to the opening balance of retained earnings. Upon adoption, the total amount of gross unrecognized tax benefits was $22.4 million. Included in the balance were approximately $9.5 million of unrecognized tax benefits that, if recognized, would affect the effective tax rate. We are currently under audit by the Internal Revenue Service. It is possible that the amount of the liability for unrecognized tax benefits, including the unrecognized tax benefits related to the audits referenced above, may change within the next 12 months. Based on the status of the case, we expect to reduce our unrecognized tax benefits by approximately $5.0 million within the next twelve months.

In accordance with our accounting policy, it recognizes accrued interest and penalties related to unrecognized tax benefits in the Provision for income taxes. This policy did not change as a result of the adoption of FIN No. 48. We have accrued interest and penalties as of the date of adoption of FIN No. 48. These amounts are not material.

The gross unrecognized tax benefits increased $0.2 million and $0.7 million for the three and six months ended June 30, 2007. Interest and penalties for the same period did not materially change.

We file income tax returns in the U.S federal jurisdiction, California, and in various foreign jurisdictions. With few exceptions, we are no longer subject to U.S. federal, state and local, or non-U.S. income tax examinations by tax authorities for years before December 31, 1997.

14. Subsequent Events:

In the third quarter ended September 30, 2007, we made an additional cash investment, among other investing enterprises, of $10.3 million in Advanced Chip Engineering Technology, or ACET, a

SILICON STORAGE TECHNOLOGY, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

14. Subsequent Events: (Continued)

privately held Taiwanese company. Our total investment now represents 38.5% of the outstanding equity of ACET at September 30, 2007.

In the third quarter ended September 30, 2007, we determined our investment in GSMC had suffered an other-than-temporary decline in value based on an independent third party valuation of our investment in GSMC. Accordingly, we recorded a charge for the quarter ended September 30, 2007 of $19.4 million.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

The following discussion may be understood more fully by reference to the consolidated financial statements, notes to the consolidated financial statements and management's discussion and analysis of financial condition and results of operations contained in our Annual Report on Form 10-K for the year ended December 31, 2006, as filed with the Securities and Exchange Commission.

The following discussion contains forward-looking statements, which involve risk and uncertainties. All forward-looking statements included in this document are based on information available to us on the date hereof, and we assume no obligation to update any such forward-looking statements. Our actual results could differ materially from those anticipated in these forward-looking statements as a result of certain factors which are difficult to forecast and can materially affect our quarterly or annual operating results. Fluctuations in revenues and operating results may cause volatility in our stock price. Please also see Item 1A. "Risk Factors."

The information below has been adjusted to reflect the restatement of our financial results which is more fully described in Note 2., "Restatement of Consolidated Financial Statements," to our condensed consolidated financial statements of this Quarterly Report on Form 10-Q and in our Annual Report on Form 10-K for the year ended December 31, 2006.

Overview

We are a leading supplier of NOR flash memory semiconductor devices for the digital consumer, networking, wireless communications and Internet computing markets. NOR flash memory is a form of nonvolatile memory that allows electronic systems to retain information when the system is turned off. NOR flash memory is used in hundreds of millions of consumer electronics and computing products annually.

We produce and sell many products based on our SuperFlash design and manufacturing process technology. Our products are incorporated into products sold by many well-known companies including Apple, Asustek, Cambridge Silicon Radio, Canon, Compal, Dell, Epson, First International Computer, or FIC, Foxconn, or Honhai, Fujitsu, Funai, Garmin, Gigabyte, GN Netcom, Haier, Hewlett Packard, Huawei, Infineon, Intel, IBM, Inventec, JVC, Lenovo, Lexmark, LG Electronics, Lite-On IT, Matsushita, or Panasonic, Micronas, Motorola, NEC, Nintendo, Philips, Pioneer, Quanta, Sagem, Samsung, Sanyo, Seagate, Sony, Sony Ericsson, TCL, Thomson, TiVO, Toshiba, USI, Western Digital, and ZTE.

We also produce and sell other semiconductor products including flash microcontrollers, smartcard ICs and modules, radio frequency, or RF, ICs and modules, NAND controllers and NAND-controller based memory modules.

One of our key initiatives is the active development of our non-memory business. Our objective is to transform SST from a pure play in flash memory to a multi-product line semiconductor company and a leading licensor of embedded flash technology. We continue to execute on our plan to derive a significant portion of our revenue from non-memory products, which includes embedded controllers, NAND-controller based modules, smartcard ICs and radio frequency ICs and modules. We believe non-memory products represent an area in which we have significant competitive advantages and also an area that can yield profitable revenue with higher and more stable gross margins than our memory products in the long run.

Sequentially, from the prior quarter, revenue from networking applications increased by 12% while revenue from of our digital consumer applications decreased by 11%, Internet computing applications increased by 12% and wireless communications increased by 3%. Compared with the same quarter a year ago, wireless communications revenue decreased by 3%, networking applications revenue decreased 21%, Internet computing revenues declined by 16% and digital consumer revenue declined by 16%.

During the first six months of 2007, we continued to make product announcements that we initially began in October 2006. This quarter we introduced our MeleodyWing wireless audio solution. This radio module allows users to wirelessly connect their surround sound speaker system to their audio-visual equipment and offers uncompressed, wire-equivalent sound quality. This product addresses the needs of the home entertainment market by delivering customers superior sound effects for both home theater surround sound and multi-room music streaming without the need for wires. We are currently broadly sampling the MelodyWing product and expect to be in volume production later this year by second half of 2008. We plan to have volume shipments of All-in-OneMemory by the second half of 2008 with our higher capacity NANDrive devices in production by the second half of 2008.

In May, 2007, we announced volume production of our Theseus Titanium 40 smartcard IC. This product offers developers an all flash memory-based smartcard IC with 100 percent User-Configurable Memory and a variety of security features. In addition, we announced the availability of new development tools for the Theseus Titanium family that complement the existing development support ecosystem for the Theseus Titanium family. This family of products has been very well received with more than 50 million units shipped worldwide since its introduction in the fourth quarter of 2005.

In the area of memory technologies, we are continuing to reduce manufacturing costs through the transition to smaller process technologies that generally carry a lower cost per die. Wafer starts are primarily now in the 0.18 and 0.25 micron geometry. We are also in the process of developing 0.13 micron and 0.12 micron process technologies.

The semiconductor industry has historically been cyclical, characterized by periodic changes in business conditions caused by product supply and demand imbalance. When the industry experiences downturns, they often occur in connection with, or in anticipation of, maturing product cycles and declines in general economic conditions. These downturns are characterized by weak product demand, excessive inventory and accelerated decline of selling prices.

The first six months of 2007 saw our share of challenges:

- In March 2007 we announced a voluntary review of our historical stock option grant practices covering the time from our initial public offering in 1995 through 2007. The Chairman of the Audit Committee of the Board of Directors completed his review with the assistance of independent outside legal counsel. The results of this review required us to restate our consolidated financial statements for prior periods. We incurred material expenses in relation to this review of $4.0 million for the three and six months ended June 30, 2007. For further information, please see Note 2. "Restatement of Financial Statements" to our condensed consolidated financial statements in this Quarterly Report on Form 10-Q and Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations" in our Form 10-K for the year ended December 31, 2006.

- The marketplace for NOR flash memory is becoming more competitive with increased market share gains by a major player. We expect that this intensified competition could cause aggressive pricing by our competitors, negatively impacting the higher density portion of our core business. While we continue to believe that the demand will remain strong in the low density NOR business, we expect the pricing environment could become more volatile.

- Our wafer capacity at one of our major foundries, Grace Semiconductor, reached its limit in 2007. We have been working with several foundries to bring up additional capacity at 180 and 250 nanometer. However, due to the manufacturing cycle-time, we do not expect this additional output to meet demand until the first quarter of 2008. We expect the supply situation to substantially improve next year, as we plan to start 120-nanometer pilot production in early 2008.

By gradually converting a significant portion of our products from 180 nanometer to 120 nanometer, we expect our unit output from Grace Semiconductor to increase by at least 25% by the end of 2008.

With these factors in mind, we made a decision to focus on our most profitable revenue opportunities while still maintaining a broad presence in the market place of our product lines. This plan will allow us to best utilize our resources and manufacturing capacity. This has resulted in the reduction of our revenue plans for 2007 but it allowed us to maintain our gross margin and limit our cash usage.

Our product sales are made primarily using short-term cancelable purchase orders. The quantities actually purchased by the customer, as well as shipment schedules, are frequently revised to reflect changes in the customer's needs and in our supply of product. Accordingly, our backlog of open purchase orders at any given time is not a meaningful indicator of future sales. Changes in the amount of our backlog do not necessarily reflect a corresponding change in the level of actual or potential sales.

We derived 87.6%, 87.7% and 89.1% of our net product revenues during 2005, 2006 and the six months ended June 30, 2007, respectively, from product shipments to Asia. Additionally, substantially all of our wafer suppliers and packaging and testing subcontractors are located in Asia.

Our top ten end customers, excluding stocking representatives and distributors, accounted for 27.2%, 20.1% and 20.6% of our net product revenues in 2005, 2006 and the six months ended June 30, 2007, respectively.

No single end customer, which we define as original equipment manufacturers, or OEMs, original design manufacturers, or ODMs, contract electronic manufacturers, or CEMs, or end users, represented 10.0% or more of our net product revenues during 2005, 2006 or the six months ended June 30, 2007.

We ship products to, and have accounts receivable from, OEMs, ODMs, CEMs, stocking representatives, distributors, and our logistics center. Our stocking representatives, distributors and logistics center reship our products to our end customers, including OEMs, ODMs, CEMs and end users. Shipments, by us or our logistic center, to our top three stocking representatives for reshipment accounted for 40.3%, 48.5% and 59.2% of our product shipments in 2005, 2006 and the six months ended June 30, 2007, respectively. In addition, the same three stocking representatives solicited sales, for which they received a commission, for 18.3%, 10.3% and 11.3% of our product shipments to end users in 2005, 2006 and the six months ended June 30, 2007, respectively.

We out-source our end customer service logistics in Asia to Silicon Professional Technology Ltd., or SPT, which supports our customers in Taiwan, China and other Southeast Asia countries. SPT provides forecasting, planning, warehousing, delivery, billing, collection and other logistic functions for us in these regions. SPT is a wholly-owned subsidiary of one of our stocking representatives in Taiwan, Professional Computer Technology Limited, or PCT. Please see a description of our relationship with PCT under "Related Party Transactions." Products shipped to SPT are accounted for as our inventory held at our logistics center, and revenue is recognized when the products have been delivered and are considered as a sale to our end customers by SPT. For the years ended December 31, 2005 and 2006, and the six months ended June 30, 2007, SPT serviced end customer sales accounting for 58.5%, 59.1% and 57.2% of our net product revenues recognized. For the years ended December 31, 2005 and 2006, and the six months ended June 30, 2007, SPT represented 69.6%, 68.9% and 68.5% of our net accounts receivable, respectively.

Critical Accounting Estimates

For information related to our revenue recognition and other critical accounting estimates, please refer to the "Critical Accounting Estimates" section of Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations" contained in our Annual Report on Form 10-K for the year ended December 31, 2006.

We adopted the provisions of FASB Interpretation Number 48, *Accounting for Uncertainty in Income Taxes*, or FIN No. 48, on January 1, 2007. The cumulative effect of adopting FIN No. 48 was a $3.2 million decrease to the opening balance of retained earnings. Upon adoption, the total amount of gross unrecognized tax benefits was $22.4 million. Included in the balance were approximately $9.5 million of unrecognized tax benefits that, if recognized, would affect the effective tax rate. We are currently under audit by the Internal Revenue Service. It is possible that the amount of the liability for unrecognized tax benefits, including the unrecognized tax benefits related to the audits referenced above, may change within the next 12 months. Based on the status of the case, we expect to reduce our unrecognized tax benefits by approximately $5.0 million within the next twelve months.

In accordance with our accounting policy, we recognize accrued interest and penalties related to unrecognized tax benefits in the Provision for income taxes. This policy did not change as a result of the adoption of FIN No. 48. We have accrued interest and penalties as of the date of adoption of FIN No. 48. These amounts are not material.

Results of Operations: Three and Six months ended June 30, 2007

Net Revenues (in thousands):

	Three Months Ended						
	June 30, 2006	March 31, 2007	June 30, 2007	2Q07-Over-2Q06 Change		2Q07-Over-1Q07 Change	
Memory Revenue	$ 82,970	$ 78,616	$ 81,299	$ (1,671)	(2.0)%	$ 2,683	3.4 %
Non-Memory Revenue	$ 15,968	9,595	$ 8,978	$ (6,990)	(43.8)%	$ (617)	(6.4)%
Product revenues	$ 98,938	88,211	$ 90,277	$ (8,661)	(8.8)%	$ 2,066	2.3 %
Technology licensing	$ 8,791	9,313	$ 9,066	$ 275	3.1 %	$ (247)	(2.7)%
Total net revenues	$ 107,729	$ 97,524	$ 99,343	$ (8,386)	(7.8)%	$ 1,819	1.9 %

	Six Months Ended			
	June 30, 2006	June 30, 2007	2Q07-Over-2Q06 Change	
Memory Revenue	$ 163,008	$ 159,915	$ (3,093)	(1.9)%
Non-Memory Revenue	$ 36,233	$ 18,573	$ (17,660)	(48.7)%
Product revenues	$ 199,241	$ 178,488	$ (20,753)	(10.4)%
Technology licensing	$ 19,019	$ 18,379	$ (640)	(3.4)%
Total net revenues	$ 218,260	$ 196,867	$ (21,393)	(9.8)%

The following discussions are based on our reportable segments described in Note 11, to our unaudited condensed consolidated financial statements.

Memory Products

Memory revenue increased 3.4% in the second quarter of 2007 from the first quarter of 2007 primarily due to an 11.0% increase in unit shipments offset by a decrease in average selling prices of 8.9%. Increases in demand for several consumer electronic and computer applications led to the

results. Memory revenue decreased 2.0% in the second quarter of 2007 compared to the second quarter of 2006 primarily due to a 14.3% decrease in average selling prices partially offset by increased unit shipments of 13.4%. The decrease in average selling prices was primarily a result of product mix coupled with some price erosion from continuing competitive pricing pressures in the low density markets. For the six months ended June 30, 2007 in comparison to the prior year, memory revenue decreased due to a 7.1% decrease in average selling prices due to competitive pricing environments offset by an 8.6% increase in unit shipments.

Non-Memory Products

Non-memory revenue decreased 6.4% in the second quarter of 2007 from the first quarter of 2007 primarily due to a 7.9% decrease in unit shipments, partially offset by a 1.5% increase in average selling prices due to product mix although we experienced some pricing pressures particularly on the smartcard IC products. Non-memory revenue decreased 43.8% in the second quarter of 2007 compared to the second quarter of 2006 primarily due to a 43.2% decrease in average selling prices largely from product mix, as well as pricing pressures on smartcard ICs coupled with a slight decrease in unit shipments. For the six months ended June 30, 2007 in comparison to the prior year, non-memory revenue decreased 48.7%, primarily due to a 43.2% decrease in average selling prices coupled with a slight increase in lower priced unit shipments.

Technology Licensing Revenue

Technology license revenue includes a combination of up-front fees and royalties. Technology licensing revenue for the second quarter of 2007 declined from the first quarter of 2007 due to timing of royalty payments. Technology licensing revenue for the second quarter of 2007 increased compared to the second quarter of 2006 as a result of timing of royalties expected to be received in the first quarter of 2007. For the six months ended June 30, 2007 technology license revenue decreased from the six months ended June 30, 2006 due to lower upfront fees as well as some fluctuation in royalties. We anticipate revenues from technology licensing may fluctuate significantly in the future.

Gross Profit (in thousands):

	Three Months Ended						
	June 30, 2006	March 31, 2007	June 30, 2007	2Q07-Over-2Q06 Change		2Q07-Over-1Q07 Change	
	As Restated						
Memory gross profit	$ 14,074	$ 15,063	$ 14,789	$ 715	5.1 %	$ (274)	(1.8)%
Memory gross margin	17.0%	19.2%	18.2%				
Non-Memory gross profit	$ 4,548	$ 2,145	$ 1,738	$ (2,810)	(61.8)%	$ (407)	(19.0)%
Non-Memory gross margin	28.5%	22.4%	19.4%				
Product gross profit	$ 18,622	$ 17,208	$ 16,527	$ (2,095)	(11.3)%	$ (681)	(4.0)%
Product gross margin	18.8%	19.5%	18.3%				
Technology licensing gross profit	8,791	9,313	9,066	275	3.1 %	(247)	(2.7)%
Technology licensing gross margin	100.0%	100.0%	100.0%				
Total gross profit	$ 27,413	$ 26,521	$ 25,593	$ (1,820)	(6.6)%	$ (928)	(3.5)%
Total gross margin	25.4%	30.1%	25.8%				

	Six Months Ended			
	June 30, 2006	June 30, 2007	2Q07-Over-2Q06 Change	
	As restated			
Memory gross profit	$ 31,792	$ 29,852	$ (1,940)	(6.1)%
Memory gross margin	19.5%	18.7%		
Non-Memory gross profit	$ 10,274	$ 3,883	$ (6,391)	(62.2)%
Non-Memory gross margin	28.4%	20.9%		
Product gross profit	$ 42,066	$ 33,735	$ (8,331)	(19.8)%
Product gross margin	21.1%	18.9%		
Technology licensing gross profit	$ 19,019	$ 18,379	$ (640)	(3.4)%
Technology licensing gross margin	100.0%	100.0%		
Total gross profit	$ 61,085	$ 52,114	$ (8,971)	(14.7)%
Total gross margin	28.0%	26.5%		

Product Gross Profit

Memory products

Gross margin of 18.2% for memory products decreased slightly in the second quarter of 2007 compared to the first quarter of 2007 largely due to a decline in average selling prices of 8.9% although there was an 11.0% increase in the number of units shipped. Serial flash devices led the declines in average selling prices. Compared to the second quarter of 2006, gross margin increased by 1.2% due to a 13.4% increase in unit shipments partially offset by a 14.3% decrease in average selling prices. For the six months ended June 30, 2007 in comparison to the prior year, memory product gross profit declined $1.9 million based on a 7.1% decrease in average selling prices from product mix coupled with more shipments of lower-priced serial flash devices.

Non-memory products

Gross margin of 19.4% for non-memory products decreased slightly in the second quarter of 2007 compared to the first quarter of 2007 due to a decrease of 7.9% in unit shipments offset by an increase of 1.5% in average selling prices. In comparison to the second quarter of 2006, gross margin decreased 9.1%. This decrease is primarily due to average selling prices which declined 43.2%, led by product mix and smartcard ICs pricing pressures, offset by an slight increase in unit shipments. For the six months ended June 30, 2007, non-memory product gross profit declined $6.4 million as average selling prices declined 43.2% coupled with higher shipments of lower-priced products. We expect some revenue fluctuation in non-memory business throughout 2007 as we expect to grow and diversify our revenue and customer base.

For other factors that could affect our gross profit, please also see Item 1A. "Risk Factors We incurred significant inventory valuation and adverse purchase commitment adjustments in 2004, 2005 and 2006 and we may incur additional significant inventory valuation adjustments in the future."

Operating Expenses (in thousands):

Research and development

	Three Months Ended						
	June 30, 2006	March 31, 2007	June 30, 2007	2Q07-Over-2Q06 Change		2Q07-Over-1Q07 Change	
	As Restated						
Research and development	$ 13,241	$ 13,774	$ 14,332	$ 1,091	8.2%	$ 558	4.1%
Percent of revenue	12.3%	14.1%	14.4%				

	Six Months Ended			
	June 30, 2006	June 30, 2007	2Q07-Over-2Q06 Change	
	As Restated			
Research and development	$ 28,135	$ 28,106	$ (29)	(0.1)%
Percent of revenue	12.9%	14.3%		

Research and development expenses include costs associated with the development of new products, enhancements to existing products, quality assurance activities and occupancy costs. These costs consist primarily of employee salaries, stock-based compensation expense and other benefit-related costs and the cost of materials such as wafers and masks.

In comparison to the first quarter of 2007, research and development expenses increased primarily due to an increase in salary and wages expenses of $638,000 from increased headcount and $224,000 from our bonus programs accruals. Partially offsetting these was a $291,000 decrease in company matched 401k expense. For the three months ended June 30, 2007 in comparison to the same quarter in the prior year, research and development expenses increased due to higher salaries and employee-related benefit costs of $228,000 related to increased headcount, higher bonus accruals of $224,000 and higher software license fees of $178,000. For the six months ended June 30, 2007 in comparison to the six months ended June 30, 2006, research and development expenses were relatively flat across all expense categories. We expect that research and development expenses will fluctuate based on the timing of engineering projects for new product introductions and the development of new technologies to support future growth.

Sales and marketing

	Three Months Ended						
	June 30, 2006	March 31, 2007	June 30, 2007	2Q07-Over-2Q06 Change		2Q07-Over-1Q07 Change	
	As Restated						
Sales and marketing	$ 7,108	$ 6,765	$ 7,539	$ 431	6.1%	$ 774	11.4%
Percent of revenue	6.6%	6.9%	7.6%				

	Six Months Ended			
	June 30, 2006	June 30, 2007	2Q07-Over-2Q06 Change	
	As Restated			
Sales and marketing	$ 15,261	$ 14,304	$ (957)	(6.3)%
Percent of revenue	7.0%	7.3%		

Sales and marketing expenses consist primarily of commissions, employee salaries, stock-based compensation expense and other benefit-related costs, as well as travel and entertainment expenses.

Sales and marketing expense increased in the second quarter of 2007 compared to the first quarter of 2007 due to higher salary and wage related expenses of $293,000 related to increased headcount, $177,000 bonus accrual from our bonus programs and higher public relations fees of $71,000, partially offset by deceased commission expenses of $120,000. In comparison to the second quarter in 2006, sales and marketing expenses increased due to higher salaries and wage related expenses of $256,000 related to increased headcount and greater accruals for bonus programs of $227,000, offset by lower commission related expenses of $130,000 and lower freight of $132,000. For the six months ended June 30, 2007, sales and marketing expenses declined due to lower commission expenses of $732,000 and lower logistic fees of $258,000, offset by increases in salaries and wages of $228,000. We expect that future sales and marketing expenses may increase in absolute dollars. In addition, fluctuations in revenues will cause fluctuations in sales and marketing expenses due to our commission expenses.

General and administrative

	Three Months Ended						
	June 30, 2006	March 31, 2007	June 30, 2007	2Q07-Over-2Q06 Change		2Q07-Over-1Q07 Change	
	As Restated						
General and administrative	$ 5,813	$ 6,755	$ 6,811	$ 998	17.2%	$ 56	0.8%
Percent of revenue	5.4%	6.9%	6.9%				

	Six Months Ended			
	June 30, 2006	June 30, 2007	2Q07-Over-2Q06 Change	
	As Restated			
General and administrative	$ 11,036	$ 13,566	$ 2,530	22.9%
Percent of revenue	5.1%	6.9%		

General and administrative expenses mainly consist of salaries, stock-based compensation, and other-benefit related costs for administrative, executive and finance personnel, recruiting costs, professional services and legal fees and allowances for doubtful accounts.

General and administrative expenses were flat in the second quarter of 2007 compared to the first quarter of 2007. For the six months ended June 30, 2007 compared to the same period a year ago, general and administrative fees increased due to higher outside tax service expenses of $881,000, higher outside professional fees from year-end accounting services of $733,000 as well as accruals for bonus plan of $549,000. We anticipate that general and administrative expenses may increase in absolute dollars as we scale our facilities, infrastructure and headcount to support our overall expected growth.

Other operating expenses

	Three Months Ended						
	June 30, 2006	March 31, 2007	June 30, 2007	2Q07-Over-2Q06 Change		2Q07-Over-1Q07 Change	
Other operating expenses	$	$	$ 4,005	$ 4,005	100.0%	$ 4,005	100.0%
Percent of revenue	0.0%	0.0%	4.0%				

	Six Months Ended			
	June 30, 2006	June 30, 2007	2Q07-Over-2Q06 Change	
Other operating expenses	$	$ 4,005	$ 4,005	100.0%
Percent of revenue	0.0%	2.0%		

As we announced in March 2007, we conducted a voluntary independent review of our historical stock option granting practices. We incurred $4.0 million of these expenses, which includes legal, tax, accounting, and other professional services, during the three and six months ended June 30, 2007. For 2007, we expect to incur additional expenses related to this review which will have a material adverse effect on our results of operations.

Interest, Dividends and Other income and expense, net

	Three Months Ended						
	June 30, 2006	March 31, 2007	June 30, 2007	2Q07-Over-2Q06 Change		2Q07-Over-1Q07 Change	
	As restated						
Other income (expense), net	$ 1,080	$ 1,810	$ 1,895	$ 815	75.5%	$ 85	4.7%
Percent of revenue	1.0%	1.9%	1.9%				

	Six Months Ended			
	June 30, 2006	June 30, 2007	2Q07-Over-2Q06 Change	
Other income (expense), net	$ 1,543	$ 3,705	$ 2,162	140.1%
Percent of revenue	0.7%	1.9%		

Interest, dividend and other income and expense for the periods presented included mainly interest and dividend income on our cash and investments. Other income (expense) increased during the three months ended June 30, 2007 in comparison to the prior quarter and the second quarter of 2006 due to higher levels of invested cash and higher short-term interest rates as well as the annual dividends declared by our investee companies. For the six months ended June 30, 2007, other income (expense) increased compared to the same period in the prior year primarily due to substantially higher levels of increased cash. We expect other income and expense will fluctuate as a result of changes in cash balances and the timing of dividends on our investments.

Interest expense

	Three Months Ended						
	June 30, 2006	March 31, 2007	June 30, 2007	2Q07-Over-2Q06 Change		2Q07-Over-1Q07 Change	
	As restated						
Interest expense	$ 65	$ 89	$ 113	$ 48	73.8%	$ 24	27.0%
Percent of revenue	0.1%	0.1%	0.1%				

	Six Months Ended			
	June 30, 2006	June 30, 2007	2Q07-Over-2Q06 Change	
Interest expense	$ 106	$ 202	$ 96	90.6%
Percent of revenue	0.0%	0.1%		

Interest expense remained relatively low in the second quarter ended March 31, 2007 as we do not have significant outstanding debt. Interest expense in the second quarter of 2007 increased compared to the second quarter of 2006 due to interest on the drawdown on our standby letter of credit. For the six months ended June 30, 2007, interest expense increased 90.6% compared to the same period of prior year due to the additional draw downs on our standby letter of credit. On August 11, 2006, we entered into a 1-year loan and security agreement with Cathay Bank, a U.S. bank, for a $40.0 million revolving line of credit all of which was available to us as of June 30, 2007. We were not in compliance with certain covenants requiring the timely filing of U.S. GAAP financial statements as of June 30, 2007. We requested waivers in regards to these requirements and Cathay Bank agreed to extend and amend our agreement until October 2007. This amendment removed the requirements to provide timely filed SEC Forms 10-Q and Form 10-K. As of June 30, 2007, a standby letter of credit in the amount of $8.0 million has been issued to Bank of America as collateral for the line of credit with Bank of America in China. As of June 30, 2007, SST China Limited has drawn RMB 32 million, or approximately $4.2 million, at the interest rate of 5.14%. In August, 2007, we amended this line to secure it solely with the guarantee of Silicon Storage Technology Inc. The amended line also adjusts the revolving amount to a maximum of RMB 58.4 million or approximately $7.7 million. All other terms are substantially the same.

Equity investments

During the first quarter of 2006, we realized a pre-tax gain of $12.2 million from the sale of 4.0 million shares of our investment in Powertech Technology, Inc. or PTI. As of June 30, 2007, we continue to own 6.3 million shares of PTI.

Also during the first quarter of 2006, we determined that our investment in Nanotech, Inc. had become impaired as Nanotech defaulted on its loan payments to certain of its business partners and began preparations to liquidate. As a result, we wrote our $3.3 million investment down to zero as well as an outstanding loan for $225,000.

During the fourth quarter of 2006, we determined based on a valuation of our investment in Grace Semiconductor Manufacturing Corporation, or GSMC, conducted by us that our investment in GSMC had become impaired. As a result, we recorded an impairment charge of $40.6 million on our existing investment. At December 31, 2006, we owned 9.8% of the outstanding stock of GSMC.

In the third quarter ended September 30, 2007, we determined our investment in GSMC had further become impaired based on GSMC's plans to raise additional equity. As a result we recorded a charge for the quarter ended September 30, 2007 of $19.4 million to write-down the carrying value of the investment to its estimated fair value.

	Three Months Ended						
	June 30, 2006	**March 31, 2007**	**June 30, 2007**	**2Q07-Over-2Q06 Change**		**2Q07-Over-1Q07 Change**	
Pro rata share of loss from equity investments	$ 233	$ 1,516	$ 1,931	$ 1,698	728.8%	$ 415	27.4%

	Six Months Ended			
	June 30, 2006	**June 30, 2007**	**2Q07-Over-2Q06 Change**	
Pro rata share of loss from equity investments	$ 472	$ 3,447	$ 2,975	630.3%

In September 2006, we invested an additional $15.9 million in Advanced Chip Engineering Technology Inc., or ACET, that increased our ownership share of ACET's outstanding capital stock from 9.4% to 46.9% and required us to change from the cost method of accounting to the equity method of accounting for this investment. Under the equity method of accounting, we are required to record our ownership interest in ACET's reported net income or loss each reporting period as well as restate our prior period financial statements to reflect the equity method of accounting from the date of the initial investment. Our operating results now include a line item titled "pro rata share of loss from equity investments" on our condensed consolidated statement of operations where we record these expenses. For the quarter ended March 31, 2007, our pro rata share of the loss in ACET was $1.5 million, compared to $239 thousand for the same period in the prior year. In the third quarter we made an additional cash investment, along other third-party investors, of $10.3 million in ACET's common stock. Our total investment represents 38.5% of the outstanding equity of ACET at September 30, 2007. We recorded a $1.8 million gain in connection with the transaction reflecting the change in our ownership interest in the underlying net assets of ACET. The gain was recorded to Additional Paid in Capital.

Provision for Income Taxes

We maintained a full valuation allowance on our net deferred tax assets as of June 30, 2007. The valuation allowance was determined in accordance with the provisions of Statement of Financial Accounting Standards No. 109, or SFAS No. 109, *Accounting for Income Taxes,* which requires an assessment of both positive and negative evidence when determining whether it is more likely than not that deferred tax assets are recoverable; such assessment is required on a jurisdiction by jurisdiction basis. Expected future U.S. losses represented sufficient negative evidence under SFAS No. 109 and accordingly, a full valuation allowance was recorded against U.S. deferred tax assets. We intend to maintain a full valuation allowance on the U.S. deferred tax assets until sufficient positive evidence exists to support reversal of the valuation allowance.

Our tax provision for the three and six months ended June 30, 2007 was $0.4 million and $1.1 million, respectively, which consists primarily of foreign withholding taxes and tentative U.S. minimum tax.

We adopted the provisions of FASB Interpretation Number 48, *Accounting for Uncertainty in Income Taxes,* or FIN No. 48, on January 1, 2007. The cumulative effect of adopting FIN No. 48 was a $3.2 million decrease to the opening balance of retained earnings. Upon adoption, the total amount of gross unrecognized tax benefits was $22.4 million. Included in the balance were approximately $9.5 million of unrecognized tax benefits that, if recognized, would affect the effective tax rate. We are currently under audit by the Internal Revenue Service. It is possible that the amount of the liability for unrecognized tax benefits, including the unrecognized tax benefits related to the audits referenced above, may change within the next 12 months. Based on the status of the case, we expect to reduce our unrecognized tax benefits by approximately $5 million within the next twelve months.

Liquidity and Capital Resources (in thousands)

	Six Months Ended	
	June 30, 2006	**June 30, 2007**
Cash provided by (used in):		
Operating activities	$ 29,284	$ 21,955
Investing activities	$ (19,546)	$ (20,391)
Financing Activities	$ 678	$ 1,620

Operating activities. The primary source of operating cash flows for the six months ended June 30, 2007 was a $14.1 million reduction in inventory resulting from capacity constraints at one of our major foundries, Grace Semiconductor and an $18.4 million reduction in accounts receivable due primarily to payments from SPT. Offsetting these sources of operating cash was a decrease of $23.3 million in accounts payable. Although the Company reported a net loss of $8.8 million for the first six months of 2007, this loss was largely offset by non-cash operating expenses including $5.5 million in depreciation, $3.0 million of stock-based compensation and $3.5 million in losses related to our equity interest in ACET.

Operating cash flows for the first six months of 2006 were primarily a result of our reported net income of $13.3 million adjusted for non-cash operating expenses of approximately $22.8 million. These non-cash charges included $5.0 million in depreciation, $4.3 million in stock-based compensation, $8.8 million in inventory provisions and a $3.5 million impairment charge on equity investments. Additional operating cash flows were provided by a $17.2 million decrease in accounts receivable and a $4.9 million decrease in inventory. Offsetting these sources of operating cash flows was a $16.0 million decrease in accounts payable to unrelated parties and a $12.2 million gain on the sale of a portion of our shares in the common stock of PTI.

Investing activities. The primary uses of cash from investing activities for the six months ended June 30, 2007 were $35.5 million used for the purchase of available-for-sale instruments and $3.7 million in purchases of fixed assets. These uses of cash were partially offset by $20.1 million in cash from the sales and maturities of available-for-sale equity investments. Our investing activities used cash of $19.5 million for the first six months of 2006. Cash used by investing activities in the first six months of 2006 was primarily attributable to the purchase of $33.7 million in available-for-sale investments, $2.4 million in capital expenditures, and $3.0 million in equity investments offset by $19.8 million of cash generated from the net sales and maturities of available-for-sale investments.

Financing activities. Cash from financing activities in the first six months of 2007 related primarily to the issuance of common stock under our employee stock purchase plan and the exercise of employee stock options of $1.2 million, and the borrowing against our line of credit of $1.0 million offset by capital lease payments of $0.7 million. Our financing activities provided cash of $0.7 million during the first six months of 2006. Cash generated from financing activities in the first six months of 2006 primarily related to the issuance of common stock under the employee stock purchase plan and the exercise of employee stock options totaling $1.4 million offset by capital lease payments of $0.6 million.

Principal sources of liquidity at June 30, 2007 consisted of $167.3 million of cash, cash equivalents and short-term available-for-sale investments. In addition, in August 2006, we entered into a 1-year loan and security agreement with Cathay Bank, for a $40.0 million revolving line of credit. We were not in compliance with certain covenants requiring the timely filing of U.S. GAAP financial statements as of June 30, 2007. We requested waivers in regards to these requirements and Cathay agreed to extend and amend our agreement until October 2007. This amendment removed the requirements to provide timely filed SEC Forms 10-Q and Form 10-K. For more information regarding the line of credit, refer to Note 8. to our unaudited condensed consolidated financial statements.

As of June 30, 2007, other than as described below, there were no material changes in long-term debt obligations, capital lease obligations, operating lease obligations, purchase obligations or any other long-term liabilities reflected on our condensed consolidated balance sheet as compared to December 31, 2006.

Purchase Commitments. As of June 30, 2007, we had outstanding purchase commitments with our foundry vendors of $38.3 million for delivery in the next twelve months. We have recorded a liability of $15 thousand for adverse purchase commitments. In comparison, as of December 31, 2006, we had outstanding purchase commitments with our foundry vendors of $20.2 million for delivery in 2007, with a recorded liability of $119,000 for adverse purchase commitments.

Operating Capital Requirements. We believe our cash balances, together with the funds we expect to generate from operations, will be sufficient to meet our projected working capital and other cash requirements through at least the next twelve months. However, if we fail to execute to our business strategies, we could experience declines in our cash balances. In August, 2006, we entered into a 1-year loan and security agreement with Cathay Bank, a U.S. bank, for a $40.0 million revolving line of credit all of which was available to us as of December 31, 2006. The loan agreement was amended in August 2007 to mature in October 2007 as well as waive covenants requiring us to file timely SEC reports on Form 10-K for December 31, 2006 as well as Forms 10-Q for the quarters ending March 31, 2007, June 30, 2007 and September 30, 2007. We did not renew this line after its expiration. The line of credit was intended to be used for working capital but there are no restrictions in the agreement as to how the funds may be used. As of June 30, 2007, a standby letter of credit in the amount of $8.0 million has been issued against the line as collateral for the line of credit with Bank of America in China. As of June 30, 2007, SST China Limited has drawn RMB 32 million, or approximately $4.2 million U.S. dollars, at the interest rate of 5.14%. In August, 2007, we amended this line to secure it solely with the guarantee of Silicon Storage Technology Inc. The amended line also adjusts the revolving amount to a maximum of RMB 58.4 or approximately $7.7 million U.S. dollars. All other terms are substantially the same. There can be no assurance that future events will not require us to seek additional borrowings or capital and, if so required, that such borrowing or capital will be available on acceptable terms. Factors that could affect our short-term and long-term cash used or generated from operations and as a result, our need to seek additional borrowings or capital include:

- the average selling prices of our products;
- customer demand for our products;
- the need to secure future wafer production capacity from our suppliers;
- the timing of significant orders and of license and royalty revenue;
- the ability to manage our inventory levels according to plan; and
- unanticipated research and development expenses associated with new product introductions.

Please also see Item 1A. "Risk Factors Our operating results fluctuate materially, and an unanticipated decline in revenues may disappoint securities analysts or investors and result in a decline in our stock price."

In January and February 2005, multiple putative shareholder class action complaints were filed against us and certain of our directors and officers in the United States District Court for the Northern District of California. Following the filing of the putative class action lawsuits, multiple shareholder derivative complaints were filed in California Superior Court for the County of Santa Clara, purportedly on behalf of SST against certain of our directors and officers. In addition, in July and October 2006, multiple shareholder derivative complaints were filed against us and certain of our directors and officers in the United States District Court for the Northern District of California. In the event of unfavorable outcome of the suits, we may be required to pay damages. For more information, please also see Item 1A. "Risk Factors We are engaged in derivative suits, which may become time consuming, costly and divert management resources and could impact our stock price."

From time to time, we are also involved in other legal actions arising in the ordinary course of business. We have accrued certain costs associated with defending these matters. There can be no assurance that the shareholder class action complaints, the shareholder derivative complaints or other third party assertions will be resolved without costly litigation, in a manner that is not adverse to our financial position, results of operations or cash flows or without requiring royalty payments in the future which may adversely impact gross margins. No estimate can be made of the possible loss or possible range of loss associated with the resolution of these contingencies. As a result, no losses have been accrued in our financial statements as of June 30, 2007.

Recent Accounting Pronouncements

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*, or SFAS No. 157. SFAS No. 157 defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles, and expands disclosures about fair value measurements. This statement does not require any new fair value measurements; rather, it applies under other accounting pronouncements that require or permit fair value measurements. The provisions of this statement are to be applied prospectively as of the beginning of the fiscal year in which this statement is initially applied, with any transition adjustment recognized as a cumulative-effect adjustment to the opening balance of retained earnings. The provisions of this statement are to be applied prospectively as of the beginning of the fiscal year in which this statement is initially applied, with any transition adjustment recognized as a cumulative effect adjustment to the opening balance of retained earnings. SFAS No. 157 is effective for the fiscal years beginning after November 15, 2007. We do not expect a material impact from the adoption of SFAS No. 157 on our financial position and results of operations.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, or SFAS No. 159. The fair value option established by SFAS No. 159 permits, but does not require, all entities to choose to measure eligible items at fair value at specified election dates. An entity would report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. We are currently assessing what the impact of the adoption of this Statement will be on our financial position and results of operations.

In December 2007, the FASB issued SFAS No. 141 (Revised 2007), *Business Combinations* or SFAS No. 141R. SFAS No. 141R will change the accounting for business combinations. Under SFAS No. 141R, an acquiring entity will be required to recognize all the assets acquired and liabilities assumed in a transaction at the acquisition-date fair value with limited exceptions. SFAS No. 141R will change the accounting treatment and disclosure for certain specific items in a business combination. SFAS No. 141R applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. Accordingly, any business combinations we engage in will be recorded and disclosed following existing GAAP until January 1, 2009. We expect SFAS No. 141R will have an impact on accounting for business combinations once adopted but the effect is dependent upon acquisitions at that time. We are still assessing the impact of this pronouncement.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements An Amendment of ARB No. 51*, or SFAS No. 160. SFAS No. 160 establishes new accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. SFAS No. 160 is effective for fiscal years beginning on or after December 15, 2008. We have not completed our evaluation of the potential impact, if any, of the adoption of SFAS No. 160 on our consolidated financial position, results of operations and cash flows.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

We are exposed to risks associated with foreign exchange rate fluctuations due to our international manufacturing and sales activities. These exposures may change over time as business practices evolve and could negatively impact our operating results and financial condition. Currently, we do not hedge these foreign exchange rate exposures. Substantially all of our sales are denominated in U.S. dollars. An increase in the value of the U.S. dollar relative to foreign currencies could make our products more expensive and therefore reduce the demand for our products. Such a decline in the demand could reduce revenues and/or result in operating losses. In addition, a downturn in the economies of China, Japan or Taiwan could impair the value of our equity investments in companies with operations in these countries. If we consider the value of these companies to be impaired, we will write off, or expense, some or all of our investments.

At any time, fluctuations in interest rates could affect interest earnings on our cash, cash equivalents and available-for-sale investments, or the fair value of our investment portfolio. A 10% move in interest rates as of June 30, 2007 would have an immaterial effect on our financial position, results of operations and cash flows. Currently, we do not hedge these interest rate exposures. As of June 30, 2007, the carrying value of our available-for-sale investments approximated fair value. The table below presents the carrying value and related weighted average interest rates for our unrestricted and restricted cash, cash equivalents and available-for-sale investments as of June 30, 2007 (in thousands):

		Carrying Value	Interest Rate
Cash and cash equivalents variable rate	$	104,157	4.6%
Short-term avaialble-for-sale investments fixed rate	$	63,114	5.3%
	$	167,271	4.9%

Item 4. Controls and Procedures

Disclosure Controls and Procedures

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our reports filed or submitted pursuant to the Securities Exchange Act of 1934, as amended, or the Exchange Act, is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms. Disclosure controls and procedures also are designed to ensure that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, conducted an evaluation of the effectiveness of our disclosure controls and procedures (as defined in the Exchange Act Rules 13a-15(e) and 15d-15(e)) as of June 30, 2007. Based on their evaluation, the Chief Executive Officer and the Chief Financial Officer have concluded that, as of June 30, 2007, our disclosure controls and procedures were not effective because of the material weakness described below.

Material Weakness in Internal Control Over Financial Reporting

A material weakness is a deficiency, or combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis.

At June 30, 2007, we did not maintain effective controls over the completeness, accuracy, valuation and presentation and disclosure of inventory and the related cost of revenue accounts. Specifically, the controls over the recording of inventory adjustments resulting from physical inventory observations, capitalization of production variances into inventory and valuation of inventory related reserves in accordance with generally accepted accounting principles in the United States, were not effective. These control deficiencies resulted in audit adjustments to the 2006 consolidated annual and interim financial statements and in adjustments to the 2007 consolidated interim financial statements. Additionally, these control deficiencies could result in misstatements to the inventory and the related cost of revenue accounts and disclosures that would result in a material misstatement of the annual or interim consolidated financial statements that would not be prevented or detected. Accordingly, we determined that these control deficiencies constitute a material weakness at June 30, 2007.

This material weakness in internal control over financial reporting is discussed in greater detail in Item 9. "Controls and Procedures" in our Annual Report on Form 10-K for the year ended December 31, 2006.

Remediation Plan for Material Weakness

We had previously decided that our existing inventory tracking and management system needed improvement and began planning for the implementation of a new system in 2006. In August 2007, we began implementing Oracle Shop Floor Management, or OSFM, a computerized inventory tracking and management system that is integrated with our other accounting and information technology systems. We believe OSFM once completely implemented will provide the basis for the development of adequate controls over inventory. However, as of June 30, 2007 we have not completed our review and evaluation of the new system and the inventory controls surrounding OSFM.

In addition we plan to review the adequacy of our staffing and the technical knowledge and experience of our current staff as well as to improve the training and education of our people in the accounting and other departments that impact inventory controls.

Changes in Internal Control Over Financial Reporting

Except as discussed above, there have been no changes in our internal control over financial reporting during the quarter ended June 30, 2007 that have materially affected or are reasonably likely to materially affect our internal control over financial reporting, as defined in Rule 13a-15(f) under the Exchange Act.

PART II OTHER INFORMATION

Item 1. Legal Proceedings

In January and February 2005, multiple putative shareholder class action complaints were filed against SST and certain directors and officers alleging insider trading and manipulation of stock prices, in the United States District Court for the Northern District of California, following our announcement of anticipated financial results for the fourth quarter of 2004. On March 24, 2005, the putative class actions were consolidated under the caption *In re Silicon Storage Technology, Inc., Securities Litigation*, Case No. C 05 00295 PJH (N.D. Cal.). On May 3, 2005, the Honorable Phyllis J. Hamilton appointed the "Louisiana Funds Group," consisting of the Louisiana School Employees' Retirement System and the Louisiana District Attorneys' Retirement System, to serve as lead plaintiff and the law firms of Pomeranz Haudek Block Grossman & Gross LLP and Berman DeValerio Pease Tabacco Burt & Pucillo to serve as lead counsel and liaison counsel, respectively, for the class. Lead plaintiff filed a Consolidated Amended Class Action Complaint on July 15, 2005, which the Court dismissed with leave to amend on March 10, 2006. Plaintiff filed a second amended complaint on May 1, 2006, again seeking unspecified damages for alleged violations of federal securities laws during the period from April 21, 2004 to December 20, 2004. We responded with a motion to dismiss on June 19, 2006. On March 9, 2007, the Court issued an Order granting our motion to dismiss, *with prejudice*, and on March 12, 2007 entered a judgment that plaintiffs take nothing and the action be dismissed on the merits. Lead plaintiff filed a notice of appeal but did not follow through and by stipulation, the suit was dismissed.

In January and February 2005, following the filing of the putative class actions, multiple shareholder derivative complaints were filed in California Superior Court for the County of Santa Clara, purportedly on behalf of SST against certain of our directors and officers. The factual allegations of these complaints were substantially identical to those contained in the putative shareholder class actions filed in federal court. The derivative complaints asserted claims for, among other things, breach of fiduciary duty and violations of the California Corporations Code. These derivative actions were consolidated under the caption *In Re Silicon Storage Technology, Inc. Derivative Litigation*, Lead Case No. 1:05CV034387 (Cal. Super. Ct., Santa Clara Co.). On April 28, 2005, the derivative action was stayed by court order. On October 19, 2007, following the dismissal with prejudice of the putative class actions, the court lifted this stay. On December 6, 2007, plaintiffs filed a consolidated amended complaint reiterating some of the previous claims and asserting claims substantially identical to those contained in the *Chuzhoy v. Yeh* (Cal. Super. Ct., Santa Clara Co.) and *In re Silicon Storage Technology, Inc., Derivative Litigation* (N.D. Cal., San Jose Div.) putative derivative actions. We intend to continue to take all appropriate actions in response to this lawsuit. The impact related to the outcome of this matter is undeterminable at this time.

On July 13, 2006, a shareholder derivative complaint was filed in the United States District Court for the Northern District of California by Mike Brien under the caption *Brien v. Yeh, et al.*, Case No. C06-04310 JF (N.D. Cal.). On July 18, 2006, a shareholder derivative complaint was filed in the United States District Court for the Northern District of California by Behrad Bazargani under the caption *Bazargani v. Yeh, et al.*, Case No. C06-04388 HRL (N.D. Cal.). Both complaints were brought purportedly on behalf of SST against certain of our current directors and certain of our current and former officers and allege among other things, that the named officers and directors: (a) breached their fiduciary duties as they colluded with each other to backdate stock options, (b) violated Rule 10b-5 of the Securities Exchange Act of 1934 through their alleged actions, and (c) were unjustly enriched by their receipt and retention of such stock options. The *Brien* and *Bazargani* cases were consolidated into one case: *In re Silicon Storage Technology, Inc. Derivative Litigation*, Case No. C06-04310 JF and a consolidated amended shareholder derivative complaint was filed on October 30, 2006. On April 13, 2007, the court granted the parties' stipulation staying this action until after we publicly announce the results of the investigation into our historical stock option grant practices, at which time plaintiff shall have 21 days to file a second amended consolidated complaint. On October 31, 2006, a similar shareholder derivative complaint was filed in the Superior Court of the State of California for the County of Santa Clara by Alex Chuzhoy under the caption *Chuzhoy v. Yeh, et al.*, Case No. 1-06-CV-074026. This complaint was brought purportedly on behalf of SST against certain of our current directors and certain of our current and former officers and alleges among other things, that the named officers and directors breached their fiduciary duties as they colluded with each other to backdate stock options and were allegedly unjustly enriched by their actions. The *Chuzhoy* complaint also alleges that certain of our officers and directors violated section 25402 of the California Corporations Code by selling shares of our common stock while in possession of material non-public adverse information. On April 13, 2007, the court granted the parties' stipulation staying this action until after we publicly announce the results of the investigation into the historical stock option grant practices, at which time plaintiff shall have 21 days to file an amended complaint. We intend to take all appropriate action in responding to all of the complaints.

On or about July 13, 2007, a patent infringement suit was brought by OPTi Inc. in the United States District Court for the Eastern District of Texas alleging infringement of two United State patents related to a "Compact ISA-bus Interface." The plaintiff seeks a permanent injunction, and damages for alleged past infringement, as well as any other relief the court may grant that is just and proper. At this time, discovery has not yet commenced, and we intend to vigorously defend the suit.

From time to time, we are also involved in other legal actions arising in the ordinary course of business. We have accrued certain costs associated with defending these matters. There can be no assurance that the shareholder class action complaints, the shareholder derivative complaints or other third party assertions will be resolved without costly litigation, in a manner that is not adverse to our financial position, results of operations or cash flows or without requiring payments in the future which may adversely impact net income. No estimate can be made of the possible loss or possible range of loss associated with the resolution of these contingencies. As a result, no losses associated with these or other litigation have been accrued in our financial statements as of June 30, 2007.

Item 1A. Risk Factors

The matters relating to the review of our historical stock option granting practices and the restatement of our consolidated financial statements has resulted in litigation, which could harm our financial results.

In March 2007, our Board of Directors determined to conduct a voluntary review of our historical stock option grant practices covering the time from our initial public offering in 1995 through 2007. The review was led by the Chairman of the Audit Committee of the Board of Directors with the assistance of outside independent legal counsel, and began on or about March 15, 2007. As described further in Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations" and Note 2. to our consolidated financial statements to our Annual Report on Form 10-K for the year ended December 31, 2006, the Chairman of the Audit Committee has reached the conclusion that incorrect measurement dates were used for financial accounting purposes for stock option grants made in certain prior periods. As a result, we have recorded additional non-cash stock-based compensation expense, and related tax effects, related to stock option grants and have restated our historical financial statements. The review of our historical stock option granting practices has also required us to incur substantial expenses for legal, accounting, tax and other professional services, totaling $9.1 million from March 31, 2007 through November 30, 2007 and we expect to incur additional costs in the future periods. In addition, the review has diverted management's attention from our business, and could in the future harm our business, financial condition, results of operations and cash flows.

Our historical stock option granting practices and the restatement of our prior financial statements have exposed us to greater risks associated with litigation and regulatory proceedings. As described in Item 1, "Legal Proceedings," several derivative complaints have been filed against our directors and certain of our executive officers pertaining to allegations relating to stock option grants. These or future similar complaints, or any future litigation or regulatory action may not result in the same conclusions reached by the Chairman of the Audit Committee. The conduct and resolution of these matters or other litigation will be time consuming, expensive and may distract management from the conduct of our business.

We also voluntarily contacted the SEC regarding the review and, as of the date of the filing of this Quarterly Report on Form 10-Q, the SEC is continuing an informal inquiry of our historical stock option grant practices. In October 2007, we met with the SEC and provided it with a review of the status of the review and in November 2007 we voluntarily provided the SEC with further documents. We plan to continue to cooperate with the SEC in its inquiry.

While we believe that we have made appropriate judgments in concluding the correct measurement dates for option grants, the SEC may disagree with the manner in which we have accounted for and reported, or not reported, the financial impact of past option grant measurement date errors, and there is a risk that its inquiry could lead to circumstances in which we may have to further restate our prior financial statements, amend prior filings with the SEC, or otherwise take other actions not currently contemplated. Any such circumstance could also lead to future delays in filing our subsequent SEC reports and delisting of our common stock from the NASDAQ Global Market. Furthermore, if we are subject to adverse findings in any of these matters, we could be required to pay damages or penalties or have other remedies imposed upon us which could harm our business, financial condition, results of operations and cash flows. Please see Note 2. "Restatement of Consolidated Financial Statements" to our condensed consolidated financial statements for further information.

We have not been in compliance with SEC reporting requirements and NASDAQ listing requirements and may continue to face compliance issues with such regulatory bodies. If we are unable to remain in compliance with SEC reporting requirements and NASDAQ listing requirements our business will be harmed.

Due to the independent review and resulting restatements we were unable to file our periodic reports with the SEC on a timely basis and face the possibility of the delisting of our common stock from the NASDAQ Global Market. As a result of our failure to file our periodic reports on a timely basis, we will not be eligible to use a registration statement on Form S-3 to register offers and sales our securities until all periodic reports have been timely filed for at least 12 months. In addition, if the NASDAQ Listing and Hearing Review Council concludes that we are not in compliance with applicable listing requirements, then we may be unable to continue to list our stock on the NASDAQ Global Market. Despite our filing of our delinquent periodic reports we remain in violation of NASDAQ listing requirements due to our failure to hold an annual meeting of shareholders in 2007. Although we anticipate holding an annual meeting as soon as permitted under applicable federal law, if our common stock is delisted the price of our common stock and the ability of our shareholders to trade our common stock could be adversely affected. In addition, we would be subject to a number of restrictions regarding the registration and qualification of our common stock under federal and state securities laws.

We are subject to the risks of additional lawsuits from former officers and employees in connection with our historical stock option practices, the resulting restatement, and the remedial measures we have taken.

Former employees may bring lawsuits against us or engage us in arbitration relating to their stock options and other matters. These lawsuits may be time consuming and expensive, and cause further distraction from the operation of our business. The adverse resolution of any specific lawsuit could harm our business, financial condition and results of operations.

It may be difficult or costly to obtain director and officer liability insurance coverage as a result of the restatement of our financial statements.

We expect that the issues arising from our historical stock option grant practices and the related restatement will make it more difficult to obtain director and officer insurance coverage in the future. If we are able to obtain this coverage, we expect that it may be significantly more costly than in the past, which would have an adverse effect on our financial results. As a result of this and related factors, our directors and officers could face increased risks of personal liability in connection with the performance of their duties. As a result, we may have difficultly attracting and retaining qualified directors and officers, which could adversely affect our business

We may incur additional expenses in order to assist our employees with potential income tax liabilities which may arise under Section 409A of the Internal Revenue Code.

As a result of our review of our historical stock option granting practices, we have determined that a number of our outstanding stock option awards were granted at exercise prices below the fair market value of our stock on the appropriate accounting measurement date. The primary adverse tax consequence is that the re-measured options vesting after December 31, 2004 are potentially subject to option holder excise tax under Section 409A of the Internal Revenue Code and, as applicable, similar excise taxes under state law or foreign law. Our employees who hold options which are determined to have been granted with exercise prices below the fair market value of the underlying shares of common stock on the appropriate measurement date may be subject to taxes, penalties and interest under Section 409A if no action is taken to cure the options from exposure under Section 409A before December 31, 2008.

We are considering offering active employees who are option holders the opportunity to amend or exchange their options to avoid the tax consequences of Section 409A. Once we have determined a final course of action in these respects, if we undertake any such plan or process, we anticipate that we will record additional expenses in periods when such actions are taken.

Our operating results fluctuate materially, and an unanticipated decline in revenues may disappoint securities analysts or investors and result in a decline in our stock price.

Although we were profitable for the year ended December 31, 2004, we incurred net losses for the years ended December 31, 2006, 2005, 2003 and the six months ended June 30, 2007. Our operating results have fluctuated significantly and our past financial performance should not be used to predict future operating results. Our recent quarterly and annual operating results have fluctuated, and may continue to fluctuate, due to the following factors, all of which are difficult to forecast and many of which are out of our control:

- the availability, timely delivery and cost of wafers or other manufacturing and assembly services from our suppliers;
- competitive pricing pressures and related changes in selling prices;
- fluctuations in manufacturing yields and significant yield losses;
- new product announcements and introductions of competing products by us or our competitors;
- product obsolescence;
- lower of cost or market, obsolescence or other inventory adjustments;

- changes in demand for, or in the mix of, our products;
- the gain or loss of significant customers;
- market acceptance of products utilizing our SuperFlash® technology;
- changes in the channels through which our products are distributed and the timeliness of receipt of distributor resale information;
- exchange rate fluctuations;
- general economic, political and environmental-related conditions, such as natural disasters;
- changes in our allowance for doubtful accounts;
- valuation allowances on deferred tax assets based on changes in estimated future taxable income;
- difficulties in forecasting, planning and management of inventory levels;
- unanticipated research and development expenses associated with new product introductions; and
- the timing of significant orders and of license and royalty revenue.

As recent experience confirms, a downturn in the market for goods that incorporate our products can also harm our operating results.

Our operating expenses are relatively fixed, and we order materials in advance of anticipated customer demand. Therefore, we have limited ability to reduce expenses quickly in response to any revenue shortfalls.

Our operating expenses are relatively fixed, and we therefore have limited ability to reduce expenses quickly in response to any revenue shortfalls. Consequently, our operating results will be harmed if our revenues do not meet our projections. We may experience revenue shortfalls for the following reasons:

- sudden drops in consumer demand which may cause customers to cancel backlog, push out shipment schedules, or reduce new orders, possibly due to a slowing economy or inventory corrections among our customers;
- significant declines in selling prices that occur because of competitive price pressure during an over-supply market environment;
- sudden shortages of raw materials for fabrication, test or assembly capacity constraints that lead our suppliers to allocate available supplies or capacity to other customers which, in turn, harm our ability to meet our sales obligations; and
- the reduction, rescheduling or cancellation of customer orders.

In addition, political or economic events beyond our control can suddenly result in increased operating costs. In addition, we are now required to record compensation expense on stock option grants and purchases under our employee stock purchase plan which substantially increases our operating costs and impacts our earnings (loss) per share.

We incurred significant inventory valuation and adverse purchase commitment adjustments in 2004, 2005, and 2006, and the six months ended June 30, 2007 and we may incur additional significant inventory valuation adjustments in the future.

We typically plan our production and inventory levels based on internal forecasts of customer demand, which are highly unpredictable and can fluctuate materially. The value of our inventory is dependent on our estimate of future average selling prices, and, if our projected average selling prices are over estimated, we may be required to adjust our inventory value to reflect the lower of cost or market. As of June 30, 2007, we had $53.4 million of net inventory on hand, a decrease of $20.5 million, or 27.7%, from December 31, 2006. Total valuation adjustments to inventory and adverse purchase commitments were $6.3 million in the six months ended June 30, 2007 and $8.8 million in the six months ended June 30, 2006. Due to the large number of units in our inventory, even a small change in average selling prices could result in a significant adjustment and could harm our financial results. Some of our customers have requested that we ship them product that has a finished goods date of manufacture that is less than one year. As of June 30, 2006, our allowance for excess and obsolete inventories includes an allowance for our on hand finished goods inventory with a date of manufacture of greater than two years and for certain products with a date of manufacture of greater than one year. In the event that this becomes a common requirement, it may be necessary for us to provide for an additional allowance for our on hand finished goods inventory with a date of manufacture of greater than one year, which could result in a significant adjustment and could harm our financial results.

Cancellations or rescheduling of backlog may result in lower future revenue and harm our business.

Due to possible customer changes in delivery schedules and cancellations of orders, our backlog at any particular date is not necessarily indicative of actual sales for any succeeding period. A reduction of backlog during any particular period, or the failure of our backlog to result in future revenue, could harm our business in the future. We experienced a decrease in the average selling prices of our products as a result of the industry-wide oversupply and excessive inventory in the market in the second half of 2004 and the first half of 2005. Although we saw strengthening of market demand in the second half of 2005 and pricing remained relatively stable in 2006, there was price erosion in selected areas. Our business could be further harmed by industry-wide prolonged downturns in the future.

Our business may suffer due to risks associated with international sales and operations.

During 2005, 2006 and the six months ended June 30, 2007, our international product and licensing revenues accounted for 95.1%, 94.0% and 94.7% of our net revenues, respectively. Our international business activities are subject to a number of risks, each of which could impose unexpected costs on us that would harm our operating results. These risks include:

- difficulties in complying with regulatory requirements and standards;
- tariffs and other trade barriers;
- costs and risks of localizing products for foreign countries;
- reliance on third parties to distribute our products;
- extended accounts receivable payment cycles;
- potentially adverse tax consequences;
- limits on repatriation of earnings; and
- burdens of complying with a wide variety of foreign laws.

In addition, we have made equity investments in companies with operations in several Asian countries. The value of our investments is subject to the economic and political conditions particular to their industries and their countries, foreign exchange rates, and the global economy. If we determine that a change in the recorded value of an investment is other than temporary, we will adjust the value of the investment. Such an expense could have a negative impact on our operating results.

We derived 87.6%, 87.7% and 89.1% of our net product revenues from Asia during 2005, 2006 and the six months ended June 30, 2007, respectively. Additionally, substantially all of our wafer suppliers and packaging and testing subcontractors are located in Asia. Any kind of economic, political or environmental instability in this region of the world can have a severe negative impact on our operating results due to the large concentration of our production and sales activities in this region. If countries where we do business experience severe currency fluctuation and economic deflation, it can negatively impact our revenues and also negatively impact our ability to collect payments from customers. In this event, the lack of capital in the financial sectors of these countries may make it difficult for our customers to open letters of credit or other financial instruments that are guaranteed by foreign banks. Finally, the economic situation can exacerbate a decline in selling prices for our products as our competitors reduce product prices to generate needed cash.

It should also be noted that we are greatly impacted by the political, economic and military conditions in Taiwan. Taiwan and China are continuously engaged in political disputes and both countries have continued to conduct military exercises in or near the other's territorial waters and airspace. Such disputes may continue and even escalate, resulting in an economic embargo, a disruption in shipping or even military hostilities. Any of these events can delay production or shipment of our products. Any kind of activity of this nature or even rumors of such activity can harm our operations, revenues, operating results, and stock price.

We invest in companies for strategic reasons and may not realize a return on our investments.

We make investments in companies around the world to further our strategic objectives and support our key business initiatives. Such investments include investments in equity securities of public companies and investments in non-marketable equity securities of private companies, which range from early-stage companies that are often still defining their strategic direction to more mature companies whose products or technologies may directly support an Intel product or initiative. The success of these companies is dependent on product development, market acceptance, operational efficiency, and other key business success factors. The private companies in which we invest may fail because they may not be able to secure additional funding, obtain favorable investment terms for future financings, or take advantage of liquidity events such as initial public offerings, mergers, and private sales. If any of these private companies fail, we could lose all or part of our investment in that company. If we determine that an other-than-temporary decline in the fair value exists for the equity securities of the public and private companies in which we invest, we write down the investment to its fair value and recognize the related write-down as an investment loss. Furthermore, when the strategic objectives of an investment have been achieved, or if the investment or business diverges from our strategic objectives, we may decide to dispose of the investment. Our investments in nonmarketable equity securities of private companies are not liquid, and we may not be able to dispose of these investments on favorable terms or at all. The occurrence of any of these events could negatively affect our results of operations.

Terrorist attacks and threats, and government responses thereto, could harm our business.

Terrorist attacks in the United States or abroad against American interests or citizens, U.S. retaliation for these attacks, threats of additional terrorist activity and the war in Iraq have caused our customer base to become more cautious. Any escalation in these events or similar future events may disrupt our operations or those of our customers, distributors and suppliers, affect the availability of materials needed to manufacture our products, or affect the means to transport those materials to manufacturing facilities and finished products to customers. In addition, these events have had and may continue to have an adverse impact on the U.S. and world economy in general and consumer spending in particular, which could harm our business.

We do not typically enter into long-term contracts with our customers, and the loss of a major customer could harm our business.

We do not typically enter into long-term contracts with our customers. In addition, we cannot be certain as to future order levels from our customers. In the past, when we have entered into a long-term contract, the contract has generally been terminable at the convenience of the customer.

We depend on stocking representatives and distributors to generate a majority of our revenues.

We rely on stocking representatives and distributors to establish and maintain customer relationships and to sell our products. These stocking representatives and distributors could discontinue their relationship with us or discontinue selling our products at any time. The majority of our stocking representatives are located in Asia. The loss of our relationship with any stocking representative or distributor could harm our operating results by impairing our ability to sell our products to our end customers.

We depend on Silicon Professional Technology Ltd., or SPT, our logistics center, to support many of our customers in Asia.

We out-source our end customer service logistics in Asia to SPT, which supports our customers in Taiwan, China and other Southeast Asia countries. SPT provides forecasting, planning, warehousing, delivery, billing, collection and other logistic functions for us in these regions. SPT is a wholly owned subsidiary of Professional Computer Technology, or PCT, which is one of our stocking representatives in Taiwan. For the years ended December 31, 2005 and 2006, and the six months ended June 30, 2007, SPT serviced end customer sales accounting for 58.5%, 59.1% and 57.2% of our net product revenues recognized. As of December 31, 2005 and 2006, and the period ended June 30, 2007, SPT represented 69.6%, 68.9% and 68.5% of our net accounts receivable, respectively. For further description of our relationships with PCT and SPT, please refer to Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations Related Party Transactions" in our Annual Report on Form 10-K for the year ended December 31, 2006.

We do not have any long-term contracts with SPT, PCT or Silicon Professional Alliance Corporation, or SPAC, another subsidiary of PCT. SPT, PCT or SPAC may cease providing services to us at any time. If SPT, PCT or SPAC were to terminate their relationship with us we would experience a delay in reestablishing warehousing, logistics and distribution functions, and it could impair our ability to collect accounts receivable from SPT and may harm our business.

We depend on a limited number of foreign foundries to manufacture our products, and these foundries may not be able to satisfy our manufacturing requirements, which could cause our revenues to decline.

We outsource substantially all of our manufacturing and testing activities. We currently buy all of our wafers and sorted die from a limited number of suppliers. The majority of our products are manufactured by five foundries, TSMC in Taiwan, Seiko-Epson and Yasu in Japan and Grace and Shanghai Hua Hong NEC Electronic Company Limited, or HHNEC, in China. We have an equity investment in GSMC, a Cayman Islands company, which owns a wafer foundry subsidiary, Grace, in Shanghai, China. We anticipate that these foundries, together with Sanyo in Japan, Samsung in Korea and Powerchip Semiconductor Corporation, or PSC, in Taiwan will continue to manufacture substantially all of our products in the foreseeable future. If these suppliers fail to satisfy our requirements on a timely basis at competitive prices we could suffer manufacturing delays, a possible loss of revenues or higher than anticipated costs of revenues, any of which could harm our operating results.

Our revenues may be impacted by our ability to obtain adequate wafer supplies from our foundries. The foundries with which we currently have arrangements, together with any additional foundry at which capacity might be obtained, may not be willing or able to satisfy all of our manufacturing requirements on a timely basis at favorable prices. In addition, we have encountered delays in qualifying new products and in ramping-up new product production and we could experience these delays in the future. During the first quarter of 2006, we experienced fabrication issues with one of our wafer foundries and capacity constraints for certain package types at one of our backend suppliers. We are also subject to the risks of service disruptions, raw material shortages and price increases by our foundries. Such disruptions, shortages and price increases could harm our operating results.

Manufacturing capacity has in the past been difficult to secure and if capacity constraints arise in the future our revenues may decline.

In order to grow, we need to increase our present available manufacturing capacity. The existing capacity from Grace, HHNEC, TSMC and PowerChip available to us were insufficient during 2007. In addition, events that we have not foreseen could arise which would further limit our capacity. Similar to our investment in GSMC, we may determine that it is necessary to invest substantial capital in order to secure appropriate production capacity commitments. If we cannot secure additional manufacturing capacity on acceptable terms, our ability to grow will be impaired and our operating results will be harmed.

Our cost of revenues may increase if we are required to purchase manufacturing capacity in the future.

To obtain additional manufacturing capacity, we may be required to make deposits, equipment purchases, loans, joint ventures, equity investments or technology licenses in or with wafer fabrication companies. These transactions could involve a commitment of substantial amounts of our capital and technology licenses in return for production capacity. We may be required to seek additional debt or equity financing if we need substantial capital in order to secure this capacity and we cannot assure you that we will be able to obtain such financing.

If our foundries fail to achieve acceptable wafer manufacturing yields, we will experience higher costs of revenues and reduced product availability.

The fabrication of our products requires wafers to be produced in a highly controlled and ultra-clean environment. Semiconductor companies that supply our wafers have, from time to time, experienced problems achieving acceptable wafer manufacturing yields. Semiconductor manufacturing yields are a function of both our design technology and the foundry's manufacturing process technology. Low yields may result from marginal design or manufacturing process drift. Yield problems may not be identified until the wafers are well into the production process, which often makes them difficult, time consuming and costly to correct. Furthermore, we rely on independent foundries for our wafers which increases the effort and time required to identify, communicate and resolve manufacturing yield problems. If our foundries fail to achieve acceptable manufacturing yields, we will experience higher costs of revenues and reduced product availability, which could harm our operating results.

If our foundries discontinue the manufacturing processes needed to meet our demands, or fail to upgrade the technologies needed to manufacture our products, we may face production delays and lower revenues.

Our wafer and product requirements typically represent a small portion of the total production of the foundries that manufacture our products. As a result, we are subject to the risk that a foundry will cease production on an older or lower-volume manufacturing process that it uses to produce our parts. Additionally, we cannot be certain our foundries will continue to devote resources to advance the process technologies on which the manufacturing of our products is based. Either one of these events could increase our costs and harm our ability to deliver our products on time.

Our dependence on third-party subcontractors to assemble and test our products subjects us to a number of risks, including an inadequate supply of products and higher costs of materials.

We depend on independent subcontractors to assemble and test our products. Our reliance on these subcontractors involves the following significant risks:

- reduced control over delivery schedules and quality;
- the potential lack of adequate capacity during periods of strong demand;
- difficulties selecting and integrating new subcontractors;
- limited warranties on the service they provide to us;
- potential increases in prices due to capacity shortages and other factors; and
- potential misappropriation of our intellectual property.

These risks may lead to increased costs, delayed product delivery or loss of competitive advantage, which would harm our profitability and customer relationships.

Because our flash memory products typically have lengthy sales cycles, we may experience substantial delays between incurring expenses related to research and development and the generation of revenues.

Due to the flash memory product cycle we usually require more than nine months to realize volume shipments after we first contact a customer. We first work with customers to achieve a design win, which may take three months or longer. Our customers then complete the design, testing and evaluation process and begin to ramp up production, a period which typically lasts an additional nine months or longer. As a result, a significant period of time may elapse between our research and development efforts and our realization of revenue, if any, from volume purchasing of our products by our customers.

We face intense competition from companies with significantly greater financial, technical and marketing resources that could harm sales of our products.

We compete with major domestic and international semiconductor companies, many of which have substantially greater financial, technical, marketing, distribution, and other resources than we do. Many of our competitors have their own facilities for the production of semiconductor memory components and have recently added significant capacity for such production. Our low density memory products, medium density memory products, and high density memory products, if we are successful in developing these products, face substantial competition. In addition, we may in the future experience direct competition from our foundry partners. We have licensed to our foundry partners the right to fabricate products based on our technology and circuit design, and to sell such products worldwide, subject to our receipt of royalty payments. Competition may also come from alternative technologies such as ferroelectric random access memory devices, or FRAM, magneto-resistive random access memory, or MRAM, or other developing technologies.

Our markets are subject to rapid technological change and, therefore, our success depends on our ability to develop and introduce new products.

The markets for our products are characterized by:

- rapidly changing technologies;
- evolving and competing industry standards;

changing customer needs;

- frequent new product introductions and enhancements;
- increased integration with other functions; and
- rapid product obsolescence.

To develop new products for our target markets, we must develop, gain access to and use leading technologies in a cost-effective and timely manner and continue to expand our technical and design expertise. In addition, we must have our products designed into our customers' future products and maintain close working relationships with key customers in order to develop new products that meet their changing needs. In addition, products for communications applications are based on continually evolving industry standards. Our ability to compete will depend on our ability to identify and ensure compliance with these industry standards. As a result, we could be required to invest significant time and effort and incur significant expense to redesign our products and ensure compliance with relevant standards. We believe that products for these applications will encounter intense competition and be highly price sensitive. While we are currently developing and introducing new products for these applications, we cannot assure you that these products will reach the market on time, will satisfactorily address customer needs, will be sold in high volume, or will be sold at profitable margins.

We cannot assure you that we will be able to identify new product opportunities successfully, develop and bring to market new products, achieve design wins or respond effectively to new technological changes or product announcements by our competitors. In addition, we may not be successful in developing or using new technologies or in developing new products or product enhancements that achieve market acceptance. Our pursuit of necessary technological advances may require substantial time and expense. Failure in any of these areas could harm our operating results.

Our future success depends in part on the continued service of our key design engineering, sales, marketing and executive personnel and our ability to identify, recruit and retain additional personnel.

We are highly dependent on Bing Yeh, our President and Chief Executive Officer, as well as the other principal members of our management team and engineering staff. There is intense competition for qualified personnel in the semiconductor industry, in particular the highly skilled design, applications and test engineers involved in the development of flash memory technology. Competition is especially intense in Silicon Valley, where our corporate headquarters are located. We may not be able to continue to attract and retain engineers or other qualified personnel necessary for the development of our business or to replace engineers or other qualified personnel who may leave our employ in the future. Our anticipated growth is expected to place increased demands on our resources and will likely require the addition of new management and engineering personnel and the development of additional expertise by existing management personnel. The failure to recruit and retain key design engineers or other technical and management personnel could harm our business.

Our ability to compete successfully depends, in part, on our ability to protect our intellectual property rights.

We rely on a combination of patent, trade secrets, copyrights, mask work rights, nondisclosure agreements and other contractual provisions and technical measures to protect our intellectual property rights. Policing unauthorized use of our products, however, is difficult, especially in foreign countries. Litigation may continue to be necessary in the future to enforce our intellectual property rights, to protect our trade secrets, to determine the validity and scope of the proprietary rights of others, or to defend against claims of infringement or invalidity. Litigation could result in substantial costs and diversion of resources and could harm our business, operating results and financial condition regardless of the outcome of the litigation. At June 30, 2007, we held 206 patents in the United States relating to certain aspects of our products and processes, with expiration dates ranging from 2010 to 2026 and have filed for several more. In addition, we hold several patents in Europe, Japan, Korea, Taiwan, and

China. We cannot assure you that any pending patent application will be granted. Our operating results could be harmed by the failure to protect our intellectual property.

We are engaged in derivative suits, which may become time consuming, costly and divert management resources and could impact our stock price.

Securities class action law suits are often brought against companies, particularly technology companies, following periods of volatility in the market price of their securities. Irrespective of the validity or the successful assertion of such claims, we could incur significant costs and management resources in defending against such claims. We are currently facing multiple shareholder derivative complaints. The complaints were brought purportedly on behalf of SST against certain of our current and former officers and directors and allege among other things, that the named officers and directors: (a) breached their fiduciary duties as they colluded with each other to backdate stock options, (b) violated Rule 10b-5 of the Securities Exchange Act of 1934 through their alleged actions, and (c) were unjustly enriched by their receipt and retention of such stock options.

From time to time, we are also involved in other legal actions arising in the ordinary course of business. We have accrued certain costs associated with defending these matters. There can be no assurance that the shareholder class action complaints, the shareholder derivative complaints or other third party assertions will be resolved without costly litigation, in a manner that is not adverse to our financial position, results of operations or cash flows or without requiring payments in the future which may adversely impact gross margins. No estimate can be made of the possible loss or possible range of loss associated with the resolution of these contingencies. As a result, no losses have been accrued in our financial statements as of June 30, 2007.

During the course of these lawsuits there may be public announcements of the results of hearings, motions, and other interim proceedings or developments in the litigation. If securities analysts or investors perceive these results to be negative, it could harm the market price of our stock. We have incurred certain costs associated with defending these matters, and at any time, additional claims may be filed against us, which could increase the risk, expense and duration of the litigation. Further, because of the amount of discovery required in connection with this type of litigation, there is a risk that some of our confidential information could be compromised by disclosure. For more information with respect to our litigation, please also see Item 1. "Legal Proceedings."

If we are accused of infringing the intellectual property rights of other parties we may become subject to time consuming and costly litigation. If we lose, we could suffer a significant impact on our business and be forced to pay damages.

Third parties may assert that our products infringe their proprietary rights, or may assert claims for indemnification resulting from infringement claims against us. Any such claims may cause us to delay or cancel shipment of our products or pay damages that could harm our business, financial condition and results of operations. In addition, irrespective of the validity or the successful assertion of such claims, we could incur significant costs in defending against such claims.

In the past, we were sued by Atmel Corporation and Intel Corporation, among others, regarding patent infringement. Significant management time and financial resources were devoted to defending these lawsuits. We settled with Intel in May 1999 and with Atmel in June 2005.

In addition to the Atmel and Intel actions, we receive from time to time, letters or communications from other companies stating that such companies have patent rights that involve our products. Since the design of most of our products is based on SuperFlash technology, any legal finding that the use of our SuperFlash technology infringes the patent of another company would have a significantly negative effect on our entire product line and operating results. Furthermore, if such a finding were made, there can be no assurance that we cdonould license the other company's technology on commercially reasonable terms or that we could successfully operate without such technology. Moreover, if we are found to infringe, we could be required to pay damages to the owner of the protected technology and could be prohibited from making, using, selling, offering to sell or importing into the United States any products that infringe the protected technology. In addition, the management attention consumed by and legal cost associated with any litigation could harm our operating results. During the course of these lawsuits there may be public announcements of the results of hearings, motions, and other interim proceedings or developments in the litigation. If securities analysts or investors perceive these results to be negative, it could harm the market price of our stock.

If an earthquake or other natural disaster strikes our manufacturing facility or those of our suppliers, we would be unable to manufacture our products for a substantial amount of time and we would experience lost revenues.

Our corporate headquarters are located in California near major earthquake faults. In addition, some of our suppliers are located near fault lines. In the event of a major earthquake or other natural disaster near our headquarters, our operations could be harmed. Similarly, a major earthquake or other natural disaster such as typhoon near one or more of our major suppliers, like the earthquakes in April 2006 and December 2006 or the typhoons in September 2001 and July 2005 that occurred in Taiwan, could potentially disrupt the operations of those suppliers, which could then limit the supply of our products and harm our business.

A virus or viral outbreak in Asia could harm our business.

We derive substantially all of our revenues from Asia and our logistics center is located in Taiwan. A virus or viral outbreak in Asia, such as the SARS outbreak in early 2003 or threat of the Avian flu, could harm the operations of our suppliers, distributors, logistics center and those of our end customers, which could harm our business.

Prolonged electrical power outages, energy shortages, or increased costs of energy could harm our business.

Our design and process research and development facilities and our corporate offices are located in California, which is susceptible to power outages and shortages as well as increased energy costs. To limit this exposure, all corporate computer systems at our main California facilities are on battery back-up. In addition, all of our engineering and back-up servers and selected corporate servers are on generator back-up. While the majority of our production facilities are not located in California, more extensive power shortages in the state could delay our design and process research and development as well as increase our operating costs.

Our growth has in the past placed a significant strain on our management systems and resources and if we fail to manage our growth, our ability to market or sell our products or develop new products may be harmed.

Our business has in the past experienced rapid growth which strained our internal systems and future growth will require us to continuously develop sophisticated information management systems in order to manage our business effectively. We have implemented a supply-chain management system and a vendor electronic data interface system. There is no guarantee that these measures, in themselves, will be adequate to address any growth, or that we will be able to foresee in a timely manner other infrastructure needs before they arise. Our success depends on the ability of our executive officers to effectively manage our growth. If we are unable to manage our growth effectively, our results of operations will be harmed. If we fail to successfully implement new management information systems, our business may suffer severe inefficiencies that may harm the results of our operations.

We have determined that we have a material weakness in our internal controls over financial reporting. As a result, current and potential stockholders could lose confidence in our financial reporting, which would harm our business and the trading price of our stock

Under Section 404 of the Sarbanes-Oxley Act of 2002, we are required to evaluate and determine the effectiveness of our internal control over financial reporting. We have dedicated a significant amount of time and resources to ensure compliance with this legislation for the year ended December 31, 2006 and will continue to do so for future fiscal periods. We may encounter problems or delays in completing the review, evaluation, and the implementation of improvements. Additionally, management's assessment of our internal control over financial reporting may identify deficiencies that need to be addressed in our internal control over financial reporting or other matters that may raise concerns for investors.

The restatement of financial statements in prior filings with the SEC is a strong indicator of the existence of a material weakness in the design or operation of internal control over financial reporting. However, we have concluded that the control deficiencies that resulted in the restatement of the previously issued consolidated financial statements did not constitute a material weakness as of June 30, 2007 because management determined that as of June 30, 2007 there were effective controls designed and in place to prevent or detect a material misstatement and therefore the likelihood of stock-based compensation, deferred compensation and deferred tax assets being materially misstated is unlikely. However, as of June 30, 2007, we did not maintain effective controls over the completeness, accuracy, valuation and presentation and disclosure of inventory and the related cost of revenue accounts. Specifically, our controls over the recording of inventory adjustments resulting from physical inventory observations, capitalization of production variances into inventory and valuation of inventory related reserves in accordance with generally accepted accounting principles in the United States, were not effective. These control deficiencies resulted in audit adjustments to the 2006 consolidated annual and in adjustments to the 2007 consolidated interim financial statements. Additionally, these control deficiencies could result in misstatements to the inventory and the related cost of revenue accounts and disclosures that would result in a material misstatement of the annual or interim consolidated financial statements that would not be prevented or detected. Accordingly, we determined that these control deficiencies constitute a material weakness at June 30, 2007. Because of this material weakness, our management concluded that, as of June 30, 2007, we did not maintain effective internal control over financial reporting based on those criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). As a result, PricewaterhouseCoopers LLP, has issued an adverse opinion with respect to the effectiveness of our internal control over financial reporting and their report is included in our Annual Report on Form 10-K for the year ended December 31, 2006.

Should we determine in future fiscal periods that we have additional material weaknesses in our internal control over financial reporting, the reliability of our financial reports may be impacted, and our results of operations or financial condition may be harmed and the price of our common stock may decline.

Future changes in financial accounting standards or practices or existing taxation rules or practices may cause adverse unexpected revenue fluctuations and affect our reported results of operations.

A change in accounting standards or practices or a change in existing taxation rules or practices can have a significant effect on our reported results and may even affect reporting of transactions completed before the change is effective. New accounting pronouncements and taxation rules and varying interpretations of accounting pronouncements and taxation practice have occurred and may occur in the future. Changes to existing rules or the questioning of current practices may adversely affect our reported financial results or the way we conduct our business. For example, we adopted

SFAS No. 123(R) in the first quarter of 2006 which requires us to record charges to earnings for the stock options we grant and purchases of our common stock under our employee stock purchase plan.

Evolving regulation of corporate governance and public disclosure may result in additional expenses and continuing uncertainty.

Changing laws, regulations and standards relating to corporate governance and public disclosure, including the Sarbanes-Oxley Act of 2002, new SEC regulations and NASDAQ Marketplace rules are creating uncertainty for public companies. We continually evaluate and monitor developments with respect to new and proposed rules and cannot predict or estimate the amount of the additional costs we may incur or the timing of such costs. These new or changed laws, regulations and standards are subject to varying interpretations, in many cases due to their lack of specificity, and as a result, their application in practice may evolve over time as new guidance is provided by regulatory and governing bodies. This could result in continuing uncertainty regarding compliance matters and higher costs necessitated by ongoing revisions to disclosure and governance practices. We are committed to maintaining high standards of corporate governance and public disclosure. As a result, we have invested resources to comply with evolving laws, regulations and standards, and this investment has resulted in increased general and administrative expenses and a diversion of management time and attention from revenue-generating activities to compliance activities. If our efforts to comply with new or changed laws, regulations and standards differ from the activities intended by regulatory or governing bodies due to ambiguities related to practice, regulatory authorities may initiate legal proceedings against us and we may be harmed.

Acquisitions could result in operating difficulties, dilution and other harmful consequences.

Over the past three years we have acquired Emosyn, LLC a fabless semiconductor manufacturer specializing in the design and marketing of smartcard ICs for SIM applications, G-Plus, Inc., a semiconductor manufacturer specializing in the design and marketing of radio frequency ICs and monolithic microwave ICs and Actrans Systems Inc., a fabless semiconductor company that designs flash memory and EEPROMs. We expect to continue to evaluate and consider a wide array of potential strategic transactions, including business combinations, acquisitions and dispositions of businesses, technologies, services, products and other assets, including interests in our existing subsidiaries and joint ventures. At any given time we may be engaged in discussions or negotiations with respect to one or more of such transactions. Any such transactions could be material to our financial condition and results of operations. There is no assurance that any such discussions or negotiations will result in the consummation of any transaction. The process of integrating any acquired business may create unforeseen operating difficulties and expenditures and is itself risky. The areas where we may face difficulties include:

- diversion of management time, as well as a shift of focus from operating the businesses to issues of integration and future products;

- declining employee morale and retention issues resulting from changes in compensation, reporting relationships, future prospects, or the direction of the business;

- the need to integrate each company's accounting, management information, human resource and other administrative systems to permit effective management, and the lack of control if such integration is delayed or not implemented;

- the need to implement controls, procedures and policies appropriate for a public company at companies that prior to acquisition had lacked such controls, procedures and policies; and

- in some cases, the need to transition operations onto our technology platforms.

International acquisitions involve additional risks, including those related to integration of operations across different cultures and languages, currency risks, and the particular economic, political, and regulatory risks associated with specific countries. Moreover, we may not realize the anticipated benefits of any or all of our acquisitions. As a result of future acquisitions or mergers, we might need to issue additional equity securities, spend our cash, or incur debt, contingent liabilities, or amortization expenses related to intangible assets, any of which could reduce our profitability and harm our business.

Risks Related to Our Industry

Our success is dependent on the growth and strength of the flash memory market.

Substantially all of our products, as well as all new products currently under design, are stand-alone flash memory devices or devices embedded with flash memory. A memory technology other than SuperFlash may be adopted as an industry standard. Our competitors are generally in a better financial and marketing position than we are from which to influence industry acceptance of a particular memory technology. In particular, a primary source of competition may come from alternative technologies such as FRAM or MRAM devices if such technology is commercialized for higher density applications. To the extent our competitors are able to promote a technology other than SuperFlash as an industry standard; our business will be seriously harmed.

The selling prices for our products are extremely volatile and have historically declined during periods of over capacity or industry downturns.

The semiconductor industry has historically been cyclical, characterized by periodic changes in business conditions caused by product supply and demand imbalance. When the industry experiences downturns, they often occur in connection with, or in anticipation of, maturing product cycles and declines in general economic conditions. These downturns are characterized by weak product demand, excessive inventory and accelerated decline of selling prices. We experienced a decrease in the average selling prices of our products as a result of the industry-wide oversupply and excessive inventory in the market in the second half of 2004 and the first half of 2005. Although we saw strengthening of market demand in the second half of 2005 and pricing remained relatively stable in 2006, there was price erosion in selected areas. Our business could be further harmed by industry-wide prolonged downturns in the future.

There is seasonality in our business and if we fail to continue to introduce new products this seasonality may become more pronounced.

Sales of our products in the consumer electronics applications market are subject to seasonality. As a result, sales of these products are impacted by seasonal purchasing patterns with higher sales generally occurring in the second half of each year. In the past we have been able to mitigate such seasonality with the introduction of new products throughout the year. If we fail to continue to introduce new products, our business may suffer and the seasonality of a portion of our sales may become more pronounced.

Item 6. Exhibits.

(a) *Exhibits.*

We incorporate by reference all exhibits filed in connection with our Annual Report on Form 10-K for the year ended December 31, 2006.

10.19	2007 Executive Bonus Plan.
31.1	Certification of President and Chief Executive Officer required by Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended.
31.2	Certification of Senior Vice President, Finance and Chief Financial Officer required by Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended.
32.1*	Certification of President and Chief Executive Officer, as required by Rule 13a-14(b) of the Securities Exchange Act of 1934, as amended, and Section 1350 of Chapter 63 of Title 18 of the United States Code (18 U.S.C. 1350).
32.2*	Certification of Senior Vice President, Finance and Chief Financial Officer, as required by Rule 13a-14(b) of the Securities Exchange Act of 1934, as amended, and Section 1350 of Chapter 63 of Title 18 of the United States Code (18 U.S.C. 1350).

* The certifications attached as Exhibit 32.1 and Exhibit 32.2 accompany the Quarterly Report on Form 10-Q, are not deemed filed with the Securities and Exchange Commission and are not to be incorporated by reference into any filing of Silicon Storage Technology, Inc. under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended (whether made before or after the date of the Form 10-Q), irrespective of any general incorporation language contained in such filing.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, in the City of Sunnyvale, County of Santa Clara, State of California, on the 18^{th} day of January, 2008.

SILICON STORAGE TECHNOLOGY, INC.

By:

/s/ BING YEH

Bing Yeh
Chairman, President and Chief Executive Officer
(Principal Executive Officer)

/s/ JAMES B. BOYD

James B. Boyd
Senior Vice President, Finance, and Chief Financial Officer
(Principal Financial and Accounting Officer)

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