SILICON STORAGE TECHNOLOGY INC
Form 10-Q
August 14, 2001

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934. For the quarterly period ended June 30, 2001.

OR

[ ] 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 Company 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)
Company's telephone number, including area code:	(408) 735-9110

Indicate by check mark whether the Company (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 Company was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes /X/ No / /

Number of shares outstanding of our Common Stock, no par value, as of the latest practicable date, July 31, 2001: 91,035,352

SILICON STORAGE TECHNOLOGY, INC.

FORM 10-Q: QUARTER ENDED JUNE 30, 2001
TABLE OF CONTENTS

Part I - FINANCIAL INFORMATION

Item 1. Condensed Consolidated Financial Statements:
Condensed Consolidated Statements of Operations....................3
Condensed Consolidated Balance Sheets..............................4
Condensed Consolidated Statements of Cash Flows....................5
Notes to Condensed Consolidated Financial Statements...............6

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations...13

Item 3. Quantitative and Qualitative Disclosures About Market Risk.........25

Part II - OTHER INFORMATION

Item 1. Legal Proceedings..27

Item 4. Submission of Matters to a Vote of Security Holders................28

Item 6. Exhibits and Reports on Form 8-K...................................28

PART I

Item 1. Condensed Consolidated Financial Statements

SILICON STORAGE TECHNOLOGY, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share data)

	Three months ended June 30,		Six months en
	2000	2001	2000
	(unaudited)	(unaudited)	(unaudited)
Net revenues:			
Product revenues - unrelated parties	$ 92,306	$ 31,847	$ 147,976
Product revenues - related parties	9,770	21,050	15,913
License revenues	1,110	9,818	1,611
Total net revenues	103,186	62,715	165,500
Cost of revenues	57,084	38,037	93,559
Gross profit	46,102	24,678	71,941

Operating expenses:			
Research and development	9,181	12,425	17,257
Sales and marketing	5,876	6,179	10,503
General and administrative	3,680	5,637	6,319
Total operating expenses	18,737	24,241	34,079
Income from operations	27,365	437	37,862
Interest and other income	3,082	1,469	3,100
Interest expense	(101)	(87)	(545)
Income before provision for income taxes	30,346	1,819	40,417
Provision for income taxes	7,810	692	8,237
Net income	$ 22,536	$ 1,127	$ 32,180
Net income per share - basic	$ 0.25	$ 0.01	$ 0.39
Shares used in per share calculation	88,753	90,982	82,530
Net income per share - diluted	$ 0.24	$ 0.01	$ 0.36
Shares used in per share calculation	95,842	96,001	90,444

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

3

SILICON STORAGE TECHNOLOGY, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands)

ASSETS

	December 31, 2000	Ju
	(unaudited)	(una
Current assets:		
Cash and cash equivalents	$ 109,086	$
Restricted cash	-	
Short-term available-for-sale investments	139,963	
Trade accounts receivable-unrelated parties, net	106,258	
Trade accounts receivable-related parties, net	20,000	
Inventories	73,290	
Deferred tax asset	9,491	
Other current assets	14,835	
Total current assets	472,923	
Equipment, furniture and fixtures, net	16,874	

Long-term available-for-sale investments	-	
Equity investments	19,369	
Other assets	3,424	
Total assets	$ 512,590	$

LIABILITIES		
Current liabilities:		
Notes payable, current portion	$ -	$
Trade accounts payable-unrelated parties	39,184	
Trade accounts payable-related parties	7,339	
Accrued expenses and other liabilities	33,879	
Deferred revenue-unrelated parties	15,274	
Deferred revenue-related parties	-	
Total current liabilities	95,676	
Other liabilities	279	
Total liabilities	95,955	

SHAREHOLDERS' EQUITY		
Common stock	330,310	
Accumulated other comprehensive income	132	
Retained earnings	86,193	
Total shareholders' equity	416,635	
Total liabilities and shareholders' equity	$ 512,590	$

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

4

SILICON STORAGE TECHNOLOGY, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

	Six Months Ended J	
	2000	
	(unaudited)	(
Cash flows from operating activities:		
Net income	$ 32,180	
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation/amortization	2,855	
Provision for doubtful accounts receivable	25	
Provision for excess and obsolete inventories and write down to market	1,742	

Deferred income taxes	(1,900)
Tax benefit from employee stock plans	8,552
(Gain) loss on sale of equipment	(62)
Changes in operating assets and liabilities:	
Accounts receivable-unrelated parties	(41,901)
Accounts receivable-related parties	(3,869)
Inventories	(26,500)
Other current and noncurrent assets	(4,180)
Trade accounts payable-unrelated parties	16,597
Trade accounts payable-related parties	-
Accrued expenses and other current liabilities	10,487
Deferred revenue-unrelated parties	6,413
Deferred revenue-related parties	-
Net cash provided by (used in) operating activities	439
Cash flows from investing activities:	
Restricted cash	-
Investment in equity securities	(17,110)
Acquisition of equipment, furniture and fixtures	(4,501)
Proceeds from sale of property and equipment	62
Purchases of available-for-sale investments	(45,958)
Sales and maturities of available-for-sale investments	-
Net cash used in investing activities	(67,507)
Cash flows from financing activities:	
Borrowings	39,750
Repayments	(59,037)
Issuance of shares of common stock	255,846
Other	(82)
Net cash provided by financing activities	236,477
Net increase (decrease) in cash and cash equivalents	169,409
Cash and cash equivalents at beginning of period	1,223
Cash and cash equivalents at end of period	$ 170,632
Supplemental Disclosure of Cash Flow Information:	
Cash received during the period for interest	$ 2,225
Cash paid during the period for interest	$ 545
Net cash paid during the period for income taxes	$ 3

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

5

SILICON STORAGE TECHNOLOGY, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS AT JUNE 30, 2001 (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 present 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 financial statements in our Annual Report on Form 10-K, as amended, for the year ended December 31, 2000 and the Quarterly Report on Form 10-Q for the three months ended March 31, 2001.

The year-end balance sheet at December 31, 2000 was derived from audited financial statements, but does not include all disclosures required by generally accepted accounting principles.

Recent Accounting Pronouncements

In June 1998, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 133, "Accounting for Derivatives and Hedging Activities." SFAS No. 133 establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities. In July 1999, the FASB issued SFAS No. 137, "Accounting for Derivative Instruments and Hedging Activities-Deferral of the Effective Date of FASB Statement No. 133," which deferred the effective date until the first fiscal year beginning after June 15, 2000. In June 2000, the FASB issued SFAS Statement No. 138, "Accounting for Certain Derivative Instruments and Certain Hedging Activities-an Amendment of SFAS No. 133." SFAS No. 138 amends certain terms and conditions of SFAS No. 133. SFAS No. 133 requires that all derivative instruments be recognized at fair value as either assets or liabilities in the statement of financial position. The accounting for changes in the fair value (i.e., gains or losses) of a derivative instrument depends on whether it has been designated and qualifies as part of a hedging relationship and further, on the type of hedging relationship. We adopted SFAS No. 133, as amended, in our quarter ending March 31, 2001. The adoption of SFAS No. 133 did not have a material impact on our financial statements.

In July 2001, the FASB issued SFAS No. 141, "Business Combinations." SFAS No. 141 requires the purchase method of accounting for business combinations initiated after June 30, 2001 and eliminates the pooling-of-interests method. We believe the adoption of SFAS No. 141 will not have a significant impact on our financial statements.

In July 2001, the FASB issued SFAS No. 142, "Goodwill and Other Intangible Assets," which is effective for fiscal years beginning after December 15, 2001. SFAS No. 142 requires, among other things, the discontinuance of goodwill amortization. In addition, the standard includes provisions upon adoption for the reclassification of certain existing recognized intangibles as goodwill, reassessment of the useful lives of existing recognized intangibles, reclassification of certain intangibles out of previously reported goodwill and the testing for impairment of existing goodwill and other intangibles. We are currently assessing but have not yet determined the impact of SFAS No. 142 on our financial position and results of operations.

6

2. Computation of Net Income Per Share

We have computed and presented net income per share under two methods, basic and

diluted. Basic net income per share is computed by dividing net income by the weighted average number of common shares outstanding for the period. Diluted net income per share is computed by dividing net income 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 per share is as follows (in thousands, except per share amounts):

	Three months ended June 30,	
	2000	2001
Numerator - Basic		
Net income	$ 22,536	$ 1,127
Denominator - Basic		
Weighted average common stock outstanding	88,753	90,982
Basic net income per share	$ 0.25	$ 0.01
Numerator - Diluted		
Net income	$ 22,536	$ 1,127
Denominator - Diluted		
Weighted average common stock outstanding	88,753	90,982
Dilutive potential of common stock equivalents:		
Options	7,089	5,019
	95,842	96,001
Diluted net income per share	$ 0.24	$ 0.01

Anti-dilutive stock options to purchase approximately 66,000 shares and 2,809,000 shares of common stock were excluded from the computation of diluted net income per share for the six months ended June 30, 2000 and 2001, respectively, because the exercise price of these options exceeded the average fair market value of our common stock for the six months ended June 30, 2000 and 2001.

3. Marketable Securities

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 two major financial institutions.

Our investments comprise federal, state, and municipal government obligations and foreign and public corporate equity securities. Investments with maturities of less than one year at the balance sheet date are considered short term and investments with maturities greater than one year at the balance sheet date are considered long term. All these investments 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. Realized gains and realized losses for the six months ended June 30, 2001 were not material.

3. Marketable Securities (continued):

The fair value of marketable securities as of June 30, 2001 were as follows (in thousands):

	Amortized Cost	Unrealized Gain	Fair Value
Corporate bonds and notes	$ 29,240	$ 33	$ 29,273
Government bonds and notes	110,508	317	110,825
Total bonds and notes	$ 139,748	$ 350	140,098
Less amounts classified as cash equivalents			(8,321)
Total long and short-term marketable securities			$ 131,777
Contractual maturity dates for investments:			
Less than 1 year			$ 121,648
1 to 5 years			10,129
			$ 131,777

The fair value of marketable securities as of December 31, 2000 were as follows (in thousands):

	Amortized Cost	Unrealized Gain (Loss)	Fair Value
Corporate bonds and notes	$ 69,155	$ (20)	$ 69,135
Government bonds and notes	141,523	152	141,675
Total bonds and notes	$ 210,678	$ 132	210,810
Less amounts classified as cash equivalents			(70,847)
Total short-term marketable securities			$ 139,963

4. Balance Sheet Detail

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

	December 31, 2000	June 30, 2001
Trade accounts receivable-unrelated parties	$ 107,041	$ 37,894
Less allowance for doubtful accounts-unrelated parties	(783)	(3,025
Trade accounts receivable-related parties	20,000	31,280
Less allowance for doubtful accounts-related parties	-	(187
	$ 126,258	$ 65,962

	December 31, 2000	June 30, 2001
Raw materials	$ 29,025	$ 118,012
Work in process	17,631	7,485
Finished goods	26,634	53,742
	$ 73,290	$ 179,239

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 write down our inventory value to reflect the lower of cost or market. Our inventories include high technology parts and components that are specialized in nature or subject to rapid technological obsolescence. While we have programs to minimize the required 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 estimate could have a significant impact on our financial position and results of operations.

8

4. Balance Sheet Detail (continued):

	December 31, 2000	June 30, 2001
Equipment	$ 13,389	$ 14,447
Design hardware	4,234	6,353
Software	5,781	6,665
Furniture and fixtures	2,269	9,204
	25,673	36,669
Less accumulated depreciation	9,906	13,682

	15,767	22,987
Construction in progress	1,107	1,553
	$ 16,874	$ 24,540

	December 31, 2000	June 30, 2001
Accrued compensation and related items	$ 14,509	$ 4,378
Accrued income tax payable	11,292	3,658
Accrued liabilities-related parties	356	1,298
Customer advances	630	5,927
Other accrued liabilities	7,092	8,436
	$ 33,879	$ 23,697

5. Commitments

In December 2000, we committed, subject to certain business conditions, to prepay $50.0 million to a vendor in 2001 to secure increased wafer capacity in 2002 and 2003. In the second quarter of 2001, in response to weakening product demand and economic conditions, we renegotiated the commitment to extend the payment to 2002. As of June 30, 2001, we had prepaid a total of $5.0 million towards this commitment. At June 30, 2001, the amount was included in other current assets on the balance sheet.

6. Contingencies

On January 3, 1996, Atmel Corporation sued us in the U.S. District Court for the Northern District of California. Atmel's complaint alleged that we willfully infringe five U.S. patents owned by or exclusively licensed to Atmel. Atmel later amended its complaint to allege infringement of a sixth patent. Regarding each of these six patents, Atmel sought a judgment that we infringe the patent, an injunction prohibiting future infringement, and treble damages, as well as attorney's fees and expenses.

On two of the six patents, the District Court ruled by summary judgment that we did not infringe. Two of the other patents were invalidated by another U.S. District Court in a proceeding to which we were not a party, but this decision was later reversed by the Federal Circuit Court of Appeals. Thus, four patents remain at issue in Atmel's District Court case against us.

On February 17, 1997, Atmel filed an action with the International Trade Commission, or ITC, against two suppliers of our parts, involving four of the six patents that Atmel alleged that we infringed in the District Court case above. We intervened as a party to that investigation. Pursuant to indemnification agreements with these suppliers, we were obligated to indemnify both to the extent provided in those agreements. As more fully described below, the settlement with Winbond terminated our indemnity obligations to that company.

As to one of these four patents, Atmel's claims were withdrawn because of the summary judgment granted by the District Court, as described above. The administrative law judge, or ALJ, who makes recommended determinations to the ITC, ruled that we did not infringe the remaining three patents. As to one of these patents, U.S. Patent No. 4,451,903 ("the `903 patent,"

also known as "Silicon Signature"), the ALJ ruled on May 17, 2000 that it is invalid and unenforceable because the patent did not name the proper inventors and because Atmel intentionally misled the U.S. Patent Office. On October 16, 2000, the ITC overturned the ALJ's recommendation on the `903 patent and ruled that we could not import into the United States certain products that use this circuit. We appealed the ITC ruling and in January 2001 the Federal Circuit Court issued an order upholding the ITC's decision, but has not yet issued a written opinion setting forth the basis of that order. The Limited Exclusion order expires September 14, 2001. The ITC also ruled that we do not infringe the two other patents at issue ("the `811 and `829" patents). Atmel appealed that determination but dropped the appeal. On May 8, 2001, we filed a motion with the Commission to terminate the Limited Exclusion Order based on newly discovered evidence. The motion is pending and we do not know when, and what, the Commission's response will be.

In April 2001, Atmel filed motions for summary judgment on the `811 and `829 patents as well as the `903 patent. On May 11, 2001 we filed our opposition papers with the court and filed motions for summary judgment that the `903 patent is invalid. The trial court denied Atmel's motion for summary judgment and our motion for summary judgment. We currently have two motions for sanctions pending before the trial court based on various discovery abuses by Atmel. The motions were argued July 27, 2001, and have been submitted. The motions for sanctions were granted in part and denied in part. The trial court set the trial date on all issues for January 22, 2002.

On October 1, 2000, we announced a settlement in our lawsuit with Winbond Electronics of Taiwan. We filed a lawsuit against Winbond in July 1998 in the U.S. District Court in San Jose, California pursuant to the termination of our SuperFlash technology licensing agreement with Winbond. As part of the settlement, Winbond agreed to a consent judgment and will not contest the validity and appropriateness of SST's termination of the licensing agreement in June 1998. This settlement concludes all litigation between us and Winbond. We received $10.4 million and $10.0 million in license fees during 2000 and for the six months ended June 30, 2001, respectively, as part of this settlement.

From time to time, we are also involved in other legal actions arising in the ordinary course of business. While we have accrued certain amounts for the estimated legal costs associated with defending these matters, there can be no assurance the Atmel complaint 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.

7. Line of Credit

As of June 30, 2001 we had no borrowings on our line of credit. As of June 30, 2001, our line of credit was for $35.0 million. This agreement expires September 2002. Borrowing is limited to 80.0% of eligible worldwide accounts receivable and is also reduced by any letters of credit issued under a $35.0 million sub-agreement to this line. As of June 30, 2001 there was no credit available under this line, and we had approximately $12.5 million in restricted cash to secure our letters of credit. Subsequent to June 30, 2001, we renegotiated certain terms related to the eligible accounts receivable, resulting in a substantial increase in our availability under the line of credit. As a result, as of July 18, 2001, the restricted cash balance of $12.5 million had been released to us. The line bears interest at a rate of the bank's reference rate

plus 0.5% (7.5% at June 30, 2001). There is a minimum interest rate of 6.0%. We are required to maintain specified levels of tangible net worth. Under the agreement we are not permitted to pay a dividend. We must pay an unused line fee at the annual rate of one quarter of one percent on the unused portion. As of June 30, 2001, we were in compliance with the covenants of this agreement.

8. Segment Information

Our operations involve the design, development, manufacturing, marketing and technical support of our nonvolatile memory products. We offer low and medium density devices that target a broad range of existing and emerging applications in the digital consumer, networking, wireless communications and Internet computing markets. Our products are differentiated based upon attributes such as density, voltage, access speed, package and predicted endurance. We also license our technology for use in non-competing applications.

Previously we managed our business in two reportable segments: Flash products and Technology Licensing. In January 2001, we introduced further granularity into our management information systems which now allow us to segregate the Flash products segment into three separate business units. These business units are considered reportable segments. The new segments which comprise the former Flash products segment are: the Standard Memory Product Group, or SMPG, the Application Specific Product Group, or ASPG, and the Special Product Group, or SPG. We make financial decisions and allocate resources based on the information that we receive from this internal management system. We do not allocate

operating expenses, interest income or expense, other income, net or the provision for income taxes to any of these segments for internal reporting purposes, as we do not believe that allocating the expense is material in evaluating a business unit's performance. Information for the prior period has been restated to conform to the new presentation.

The following table shows our product revenues and gross profit at standard margins for each segment:

	Three Months Ended June 30, 2001		Six Months June 30,
	Revenues	Gross Profit	Revenues
SMPG	$ 29,407	$ 1,696	$ 79,744
ASPG	21,683	12,087	49,538
SPG	1,807	1,077	3,544
Technology Licensing	9,818	9,818	16,187
	$ 62,715	$ 24,678	$ 149,013

	Three Months Ended June 30, 2000		Six Months June 30,
	Revenues	Gross Profit	Revenues
SMPG	$ 96,340	$ 42,364	$ 155,786

ASPG	3,148	1,354	4,570
SPG	2,588	1,274	3,533
Technology Licensing	1,110	1,110	1,611
	$ 103,186	$ 46,102	$ 165,500

SMPG includes our three standard flash memory product families: the Small-Sector Flash, or SSF, family, the Multi-Purpose Flash, or MPF, family, and the Many-Time Programmable, or MTP, family and certain custom products based on these standard flash memory families. These product families allow us to produce products optimized for cost, quality and functionality to support the broad range of applications that use nonvolatile memory products.

ASPG includes FlashBank, Concurrent SuperFlash, Serial Flash, Firmware Hub, or FWH, and LPC flash products. These products are designed to address specific applications such as cellular phones, pagers, PDAs, set-top boxes, hard disk drives and PC BIOS applications. This business unit also includes our flash embedded controllers and mass storage products such as the FlashFlex51, ADC, ADM, and CompactFlash Card product families, to address the markets for digital cameras, Internet appliances, PDAs, MP3 players, Set-top boxes and other types of mass data storage applications.

SPG includes ComboMemory, ROM/RAM Combos, SRAM-related and other special flash products.

Technology Licensing includes both up front license fees and royalties which are recognized in accordance with our revenue recognition policy.

11

9. Comprehensive Income

The components of comprehensive income, net of tax, are as follows (in thousands):

	Three Months Ended		Six Mo
	June 30, 2000	June 30, 2001	June 30, 2000
Net income	$ 22,536	$ 1,127	$ 32,180
Other comprehensive income:			
Change in net unrealized gains on investments, net of tax	56	13	56
Total comprehensive income	$ 22,592	$ 1,140	$ 32,236

The components of accumulated other comprehensive income are as follows (in thousands):

	December 31, 2000	June 30, 2001
Net unrealized gains on investments, net of tax	$ 132	$ 217

10. Equity Investment

On March 6, 2001 we invested $50.0 million in Grace Semiconductor Manufacturing Corporation (GSMC), a Cayman Islands company. The investment is for a wafer foundry project located in Shanghai, P.R.C. As a result, we acquired 5% of the outstanding equity of GSMC. This investment is carried at cost.

On June 20, 2001, we invested an additional $2.1 million in a memory module manufacturer. This recent investment increased our ownership to 10.3%. This investment is carried at cost.

12

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 condensed consolidated financial statements, notes to the condensed 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, as amended, for the year ended December 31, 2000, as filed with the Securities and Exchange Commission.

The following discussion contains forward-looking statements, which involve risk and uncertainties. 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 refer to the section below entitled "Business Risks".

Overview

We are a leading supplier of flash memory semiconductor devices for the digital consumer, networking, wireless communications and Internet computing markets.

The semiconductor industry has historically been cyclical, characterized by wide fluctuations in product supply and demand. From time to time, the industry has also experienced significant downturns, often in connection with, or in anticipation of declines in general economic conditions. Downturns of this type occurred in 1996, 1997 and 1998. These downturns have been characterized by weakening product demand, production over-capacity and accelerated decline of selling prices, and in some cases have lasted for more than a year. We began to experience a sharp downturn in several of our markets late in the fourth quarter of 2000, as our customers reacted to weakening demand for their products. During the early portion of the first quarter of 2001, market conditions had not improved and our customers continued to return product, cancel backlog and/or push out shipments. However, during the latter portion of the first quarter, we began to see a slowing of this activity and some of our customers had begun to place orders, primarily in the personal computer segment. The second quarter

continued to be a difficult quarter for the industry and for us due to the excess inventory situation and a continuing slowdown in new orders. In reaction to sluggish sales, we were able to work with our foundry partners to significantly reduce our wafer-start rate in order to control our inventory level. Compared with the first quarter, we experienced weaker demand across all major applications except graphics cards, PDAs and digital cameras. In addition, despite the orders received at the end of the first quarter, we also experienced weaker demand in the personal computer segment during the second quarter. The networking and wireless communications segments continue to be very weak. Our business could be harmed by industry-wide fluctuations in the future.

We derived 74.9% and 78.4% of our net product revenues during the six months ended June 30, 2000 and 2001, respectively, from product shipments to Asia. Additionally, all of our major wafer suppliers and packaging and testing subcontractors are located in Asia.

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.

Sales to direct customers and foreign stocking representatives are recognized upon shipment, net of an allowance for estimated returns. Sales to distributors are made primarily under arrangements allowing price protection and the right of stock rotation on merchandise unsold to customers. Because of the uncertainty associated with pricing concessions and future returns, we defer recognition of such revenues, related costs of revenues and related gross margin until we are notified by the distributor that the merchandise is sold by the distributor. In March 2001, one of our stocking representatives, Professional Computer Technology Limited ("PCT"), established a separate company, Silicon Professional Technology Ltd. ("SPT"), to provide warehousing, logistics and distribution services for us in Taiwan. SPT now services substantially all of our customers in Taiwan. For revenue recognition purposes we treat SPT as a distributor and we defer recognition of the revenue and cost of products shipped to SPT until it has been sold to the end customer. In the first half of 2001, PCT and SPT accounted for 20.9% of revenue recognized during this period.

Most of our technology licenses provide for the payment of up-front license fees and continuing royalties based on product sales. For license and other arrangements for technology that we are continuing to enhance and refine and under which we are obligated to provide unspecified enhancements, revenue is recognized over the lesser of the estimated period we have historically enhanced and developed refinements to the technology, generally three years, the upgrade period, or the remaining portion of the upgrade period from the date of delivery, provided all specified technology and documentation has been delivered, the fee is fixed or determinable and collection of the fee is reasonably assured. From time to time, we reexamine the estimated upgrade period relating to licensed technology to determine if a change in the estimated update period is needed. Revenues from license or other technology arrangements where we are not continuing to enhance and refine the technology or are not obligated to provide unspecified enhancements is recognized upon delivery, if the fee is fixed or determinable and collection of the fee is reasonably assured.

We recognize royalties received under these arrangements during the upgrade

period as revenue based on the ratio of the elapsed portion of the upgrade period to the estimated upgrade period. We recognize the remaining portion of the royalties ratably over the remaining portion of the upgrade period. We recognize royalties received after the upgrade period has elapsed when reported to us, which generally coincides with the receipt of payment.

Results of Operations: Quarter Ended June 30, 2001

Net Revenues

Net revenues were $62.7 million for the three months ended June 30, 2001 as compared to $86.3 million in the first quarter of 2001 and $103.2 million for the three months ended June 30, 2000. Revenues decreased compared to the second quarter of last year due to decreased shipment volume of our products and due to decreased average selling prices. Revenues decreased compared to the prior quarter due to the lower volume of units shipped as a result of a deterioration in market conditions which began in the fourth quarter of 2000 and continued through the second quarter of 2001. Our quarterly results are not indicative of annual results. Average selling prices fluctuate due to a number of factors including the overall supply and demand for our products in the marketplace, maturing product cycles and general economic conditions. Net revenues were $149.0 million for the six months ended June 30, 2001 as compared to $165.5 million for the comparable period in 2000. The decrease from year to year was due to decreased shipment volume of our products and decreased average selling prices.

Product Revenues. Product revenues were $52.9 million in the second quarter of 2001 as compared to $79.9 million in the first quarter of 2001 and $102.1 million for the second quarter of 2000. Product revenues decreased compared to the second quarter of last year due to decreased shipment volume of our products and due to decreased average selling prices. Product revenues decreased compared to the prior quarter due to the lower volume of units shipped as a result of a deterioration in market conditions which began in the fourth quarter of 2000 and continued through the second quarter of 2001. Product revenues decreased to $132.8 million in the first half of 2001 from $163.9 in the first half of 2000 due to decreased shipment volume of our products from period to period. We anticipate shipping volumes to continue to fluctuate due to overall industry supply and demand.

License Revenues. Revenues from license fees and royalties were $9.8 million in the second quarter of 2001, as compared to $6.4 million in the first quarter of 2001 and $1.1 million in the second quarter of 2000. The increase from the second quarter of 2000 to the second quarter of 2001 was primarily due to $5.0 million in license fees received as part of our legal settlement with Winbond. The increase from the first quarter of 2001 to the second quarter of 2001 was primarily due to increase in royalty payments received from our licensees. We anticipate an additional $5.0 million to be paid under this legal settlement in each of the remaining quarters of 2001. Revenues from license fees and royalties increased to $16.2 million for the six months ended June 30, 2001 from $1.6 million for the comparable period in 2000. The period to period increase was primarily due to $10.0 million license fees received as part of our legal settlement with Winbond and increase in royalty payments from our licensees. We anticipate that license revenues may fluctuate significantly in the future.

Gross Profit

Gross profit was $24.7 million, or 39.3% of net revenues, in the second quarter of 2001 as compared to $28.9 million, or 33.5% of net revenues, in the first quarter of 2001 and $46.1 million, or 44.7% of net revenues, in the second quarter of 2000. Gross profit decreased in absolute dollars when compared to the second quarter of 2000 and the first quarter of 2001 due primarily to write

downs and allowances for products in inventory and decreases in average selling prices. We wrote down $5.9 million of inventory in each of the first two quarters of 2001, or a total of $11.8 million for the first half of 2001. As a percentage of net revenues, gross profit increased when compared to the first quarter of 2001 primarily due to the increase in license revenues in the second quarter of 2001. Product gross margin was 28.1% for the second quarter 2001, compared to 28.2% for the first quarter of 2001 and 44.1% for the second quarter of 2000. For the six months ended June 30, 2001, gross profit was $53.6 million, or 36.0 %, compared to $71.9 million, or 43.5%, for the comparable period in 2000. Product gross margin for the six months ended June 30, 2001 decreased to 28.2% from 42.9% for the same period in 2000. The period to period decrease was primarily due to decreased unit shipments, decreased average selling prices and write downs and allowances for products in inventory.

Operating Expenses

Our operating expenses consist of research and development, sales and marketing, and general and administrative expenses. Operating expenses were $24.2 million, or 38.7% of net revenues, in the second quarter of 2001, compared to $23.4 million, or 27.2% of net revenues, in the first quarter of 2001, and $18.7 million, or 18.2% of net revenues, in the second quarter of 2000. The increase from the comparable quarter last year was due primarily to hiring additional personnel, the development of new products and improvements in our infrastructure. This is offset by the lack of profit sharing expense, as none was earned in the second quarter of 2001. The increase from the first quarter 2001 was due primarily to an increase in our allowance for doubtful accounts of $2.3 million, offset by $1.4 million in legal accruals booked in the first quarter of 2001 in connection with the Atmel litigation. Operating expenses increased to $47.7 million for the six months ended June 30, 2001 from $34.1 million for the comparable period in 2000. The period to period increase was due to hiring additional personnel, development of new products, improvements in our infrastructure, an increase in our allowance for doubtful accounts for $2.3 million, and an increase in legal accruals for $1.4 million in connection with the Atmel litigation. We anticipate that we will continue to devote substantial resources to research and development, sales and marketing and to general and administrative, and that these expenses will continue to increase in absolute dollar amounts.

14

Research and development. 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, benefits, mask tooling and the cost of outside resources that supplement the internal development team. Research and development expenses were $12.4 million, or 19.8% of net revenues, during the second quarter of 2001, as compared to $12.3 million, or 14.2% of net revenues, during the first quarter of 2001 and $9.2 million, or 8.9% of net revenues, during the second quarter of 2000. Research and development expenses increased 35.3% from the second quarter of 2000 due primarily to expenses related to increased engineering evaluation and mask costs, increased depreciation related to purchases of new engineering equipment, increased engineering headcount and occupancy costs. For the six months ended June 30, 2001, research and development expenses increased to $24.7 million from $17.3 million for the comparable period in 2000. The period to period increase was primarily due to expenses related to increased engineering and mask costs, increased depreciation related to purchases of new engineering equipment, and increased engineering headcount and occupancy costs. We expect research and development expenses to continue to increase in absolute dollars as we continue to invest in new product

offerings, drive to new deep sub-micron technologies and cost reduce our existing products.

Sales and marketing. Sales and marketing expenses consist of personnel costs, commissions to stocking representatives, travel and entertainment and promotional expenses. Sales and marketing expenses were $6.2 million, or 9.9% of net revenues, in the second quarter of 2001 as compared to $6.3 million, or 7.4% of net revenues, in the first quarter of 2001 and $5.9 million, or 5.7% of net revenues, during the second quarter of 2000. Sales and marketing expenses remained relatively flat in absolute dollars, but increased as a percentage of net revenues due to the decrease in net revenues from the first quarter of 2001 to the second quarter of 2001, as well as from the second quarter of the previous year. Sales and marketing expenses for the six months ended June 30, 2001 were $12.5 million as compared to $10.5 million for the same period in 2000. The period to period increase was primarily due to increased commissions payable on higher product revenues in the first quarter of 2001 when compared to the first quarter of 2000, increased headcount and occupancy cost and increased marketing costs. We expect sales and marketing expenses to increase in absolute dollars as we continue to expand our sales and marketing efforts.

General and administrative. General and administrative expenses consist of salaries for administrative, executive and finance personnel, recruiting costs, professional services and legal fees and allowances for doubtful accounts. General and administrative expenses were $5.6 million, or 9.0% of net revenues, in the second quarter of 2001, as compared to $4.8 million, or 5.6% of net revenues, in the first quarter of 2001 and $3.7 million, or 3.6% of net revenues, during the second quarter of 2000. Expenses increased from the second quarter of 2000 due to increased occupancy and headcount related costs, as well as depreciation expense associated with new leasehold improvements on additional leased office space. Our allowance for doubtful accounts increased by $2.3 million from the first quarter of 2001 due to the aging of certain accounts receivable during this period. This was offset by $1.4 million in legal accruals booked in the first quarter of 2001 booked in connection with the Atmel litigation. General and administrative expenses for the six months ended June 30, 2001 were $10.4 million as compared to $6.3 million for the same period in 2000. The period to period increase was due primarily to increased allowance for doubtful accounts and increased legal accrual. We anticipate that general and administrative expenses will continue to increase in absolute dollar amount as we scale our facilities, infrastructure, and head count to support our overall expected growth. We may also incur additional expenses in connection with the Atmel litigation. For further information on this litigation see "Legal Proceedings."

Interest and other income. Interest and other income was approximately $1.5 million, or 2.3% of net revenues, during the second quarter of 2001, as compared to $3.4 million, or 3.9% of net revenues, during the first quarter of 2001 and $3.1 million, or 3.0% of net revenues, during the second quarter of 2000. Interest income decreased from the second quarter of 2000 to the second quarter of 2001 and from the first quarter of 2001 to the second quarter of 2001 due to a decrease in cash ,cash equivalent and available-for-sale investments balances. Interest and other income increased to $4.8 million for the first half of 2001 from $3.1 million in the first half of 2000. The increase from period to period was due to the change in cash, cash equivalents and available-for-sale investment balances as a result of our follow-on public offering at the end of the first quarter of 2000.

Interest Expense. Interest expense was approximately $87,000 for the second quarter of 2001 as compared to $99,000 for the first quarter of 2001 and $101,000 for the second quarter of 2000. Interest expense decreased to $186,000 for the first half of 2001 from $545,000 in the first half of 2000. Interest expense relates to interest and fees under our line of credit. Fees will continue and will fluctuate depending on our use of the line of credit facility.

Provision for Income Taxes

Our income tax provision of $692,000 in the second quarter of 2001 consists of a 38.0% tax rate on income before taxes. This compares with a tax provision of $3.3 million in the first quarter of 2001 which was a 38.0% tax rate on income before taxes and a tax provision of $7.8 million in the second quarter of 2000 which was a 25.7% tax rate on income before taxes. For the first six months of 2001, we recorded an income tax provision of $4.0 million, or 38.0% tax rate on income before taxes, as compared to $8.2 million, or 20.4% tax rate on income before taxes, for the same period in 2000. The increase in the effective tax rate during 2001 is a result of our continued profitability. All of our prior year net operating losses were fully utilized by the end of the second quarter of 2000. We expect our effective tax rate to be 38.0% for the remainder of 2001. Our tax rate may change depending on our profitability and the timing of the implementation of certain tax planning strategies which are being designed to decrease the effective rate in future years.

Segment Reporting

Our operations involve the design, development, manufacturing, marketing and technical support of our non-volatile memory products. We offer low and medium density devices that target a broad range of existing and emerging applications in the digital consumer, networking, wireless communications and Internet computing markets. Our products are differentiated based upon attributes such as density, voltage, access speed, package and predicted endurance. We also license our technology for use in non-competing applications. Our reportable segments are: the Standard Memory Product Group, or SMPG, the Application Specific Product Group, or ASPG, and the Special Product Group, or SPG. Refer to Note 8 to the Condensed Consolidated Financial Statements for revenue and gross profit information by reportable segment. Note that during 2000 we had different reportable segments, and therefore the prior period information has been restated to conform to the new presentation. Our analysis of the changes for each segment is discussed below.

SMPG includes our three standard flash memory product families: the Small-Sector Flash, or SSF, family, the Multi-Purpose Flash, or MPF, family, and the Many-Time Programmable, or MTP, family and certain custom products based on these standard flash memory families. These families allow us to produce products optimized for cost and functionality to support the broad range of applications that use nonvolatile memory products. Gross margin decreased from 44.0% in the second quarter of 2000 to 13.2% in the first quarter of 2001 and to 5.8% in the second quarter of 2001 for this segment due to the inventory write-down during the first and second quarters of 2001.

ASPG includes FlashBank, Concurrent SuperFlash, Serial Flash, Firmware Hub, or FWH, and LPC flash products. These products are designed to address specific applications such as cellular phones, pagers, PDAs, set-top boxes, hard disk drives and PC BIOS applications. It also includes flash embedded controllers and our mass storage products such as the FlashFlex51, ADC, ADM, and CompactFlash Card product families, address digital cameras, digital cellular phones, Internet appliances, PDAs, MP3 players, Set-top boxes and other types of mass data storage applications. Gross margin increased from 43.0% in the second quarter of 2000 to 55.0% in the first quarter of 2001 and to 55.7% in the second quarter of 2001 for this segment due to increased shipment of the Firmware Hub product, which was introduced during the second half of 2000.

SPG includes ComboMemory, ROM/RAM Combos and SRAM-related products. Gross margin

increased from 49.2% in the second quarter of 2000 and 34.3% in the first quarter of 2001 to 59.6% in the second quarter of 2001 for this segment due to changes in the mix of the types of products sold between the reporting periods.

Revenue and gross profit related to Technology Licensing was $1.1 million for the second quarter of 2000, $6.4 million for the first quarter of 2001 and $9.8 million for the second quarter of 2001.

Recent Accounting Pronouncements

In June 1998, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 133, "Accounting for Derivatives and Hedging Activities." SFAS No. 133 establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities. In July 1999, the FASB issued SFAS No. 137, "Accounting for Derivative Instruments and Hedging Activities-Deferral of the Effective Date of FASB Statement No. 133," which deferred the effective date until the first fiscal year beginning after June 15, 2000. In June 2000, the FASB issued SFAS Statement No. 138, "Accounting for Certain Derivative Instruments and Certain Hedging Activities-an Amendment of SFAS No. 133." SFAS No. 138 amends certain terms and conditions of SFAS No. 133. SFAS No. 133 requires that all derivative instruments be recognized at fair value as either assets or liabilities in the statement of financial position. The accounting for changes in the fair value (i.e., gains or losses) of a derivative instrument depends on whether it has been designated and qualifies as part of a hedging relationship and further, on the type of hedging relationship. We adopted SFAS No. 133, as amended, in our quarter ending March 31, 2001. The adoption of SFAS No. 133 did not have a material impact on our financial statements.

In July 2001, the FASB issued SFAS No. 141, "Business Combinations." SFAS No. 141 requires the purchase method of accounting for business combinations initiated after June 30, 2001 and eliminates the pooling-of-interests method. We believe the adoption of SFAS No. 141 will not have a significant impact on our financial statements.

In July 2001, the FASB issued SFAS No. 142, "Goodwill and Other Intangible Assets," which is effective for fiscal years beginning after December 15, 2001. SFAS No. 142 requires, among other things, the discontinuance of goodwill amortization. In addition, the standard includes provisions upon adoption for the reclassification of certain existing recognized intangibles as goodwill, reassessment of the useful lives of existing recognized intangibles, reclassification of certain intangibles out of previously reported goodwill and the testing for impairment of existing goodwill and other intangibles. We are currently assessing but have not yet determined the impact of SFAS No. 142 on our financial position and results of operations.

Liquidity and Capital Resources

Operating activities. Our operating activities used cash of $34.0 million for the six month period ended June 30, 2001 as compared to generating cash of $439,000 for the six month period ended June 30, 2000. The cash used by operating activities for the six month period ended June 30, 2001 related primarily to increases in inventory of $117.7 million, accounts receivable-related parties of $11.3 million and other assets of $9.2 million and decreases in accrued expenses of $10.2 million and deferred revenues-unrelated parties of $6.6 million. Cash used in operating activities was reduced by net income of $6.6 million, a decrease in trade accounts receivable-unrelated

parties of $69.1 million and increases in trade accounts payable of $16.8 million and deferred revenues-related parties of $9.7 million and non-cash adjustments of $18.8 million, primarily relating to depreciation and amortization, inventory write-downs and increased provisions for doubtful accounts receivable. Decreased accounts receivable-unrelated parties relates to decreased shipment volume and decreased average selling prices due to the downturn in the economy. Increased accounts receivable-related parties and increased deferred revenue-related parties relates to a new distribution relationship with a company owned by one of our equity investments. The cash provided by operating activities for the six month period ended June 30, 2000 related primarily to net income of $32.2 million and increases in trade accounts payable by $16.6 million, tax benefits from employee stock plans of $8.6 million and increases in accrued expenses and deferred revenue of $16.9 million. Increases in accounts receivable and accounts receivable from related parties of $45.8 million and increases in inventory of $26.5 million mostly offset the net income and increases in accounts payable. In addition, depreciation and amortization of $2.9 million and provision for inventory write-downs of $1.7 million represented adjustments to reconcile net income to cash provided by operating activities.

Investing activities. Our investing activities used cash of $67.9 million for the six month period ended June 30, 2001, as compared to using cash of $67.5 million for the first six months of 2000. In the first quarter of 2001, we made a $50.0 million equity investment in Grace Semiconductor Manufacturing Corporation, a Cayman Islands company with operations in China, as a part of multi-phased strategic plan to expand into China. Additionally, in the second quarter of 2001, we invested an additional $2.1 million in a production subcontractor, and invested $12.5 million in restricted cash for securing our letters of credit. Capital expenditures were $11.6 million for the current six month period as compared to $4.5 million in capital expenditures for the same period of 2000. The expenditures for the six month period ended June 30, 2001 include $5.2 million of leasehold improvements on new building leases signed in 2000. Cash used in investing activities was also reduced by the excess of sales and maturities of available for sale investments over the purchases of such investments by $8.3 million.

Financing activities. Our financing activities provided cash of approximately $3.7 million during the six month period ended June 30, 2001 as compared to provided $236.5 million for the six month period ended June 30, 2000. For the current six month period, the cash provided was from $2.1 million of common stock issued under the employee stock purchase plan and the exercise of employee stock options and $1.8 million related to a leasehold improvement loan as stipulated by the lease agreement, offset by $205,000 in loan repayments and other. The cash provided for the six month period ended June 30, 2000 was primarily from the issuance of common stock for $255.8 million and primarily related to net proceeds from a follow-on public offering in which we issued and sold 12.1 million shares of common stock, a private placement in which we issued and sold 504,000 shares of common stock, and $2.2 million from common stock issued under the employee stock purchase plan and the exercise of employee stock options, offset by the repayment of our entire line of credit at the end of March, 2000.

Principal sources of liquidity at June 30, 2001 consisted of $155.2 million of cash, cash equivalents, restricted cash, short-term investments and long-term available for sale investments and the line of credit. As of June 30, 2001 we had no borrowings on our line of credit. As of June 30, 2001, our line of credit was for $35 million. This agreement expires September 2002. Borrowing is limited to 80.0% of eligible worldwide accounts receivable and is also reduced by any letters of credit issued under a $35 million sub-agreement to this line. As of June 30, 2001 there was no credit available under this line, and we had approximately $12.5 million in restricted cash to secure our letters of credit. Subsequent to June 30, 2001, we renegotiated certain terms related to the

eligible accounts receivable, resulting in a substantial increase in our availability under the line of credit. As a result, as of July 18, 2001, the restricted cash balance of $12.5 million had been released to us. The line bears interest at a rate of the bank's reference rate plus 0.5% (7.5% at June 30, 2001). There is a minimum interest rate of

6.0%. We are required to maintain specified levels of tangible net worth. Under the agreement we are not permitted to pay a dividend. We must pay an unused line fee at the annual rate of one quarter of one percent on the unused portion. As of June 30, 2001 we were in compliance with the covenants of this agreement.

Purchase Commitments. In December 2000, we committed, subject to certain business conditions, to prepay $50.0 million to a vendor in 2001 to secure increased wafer capacity in 2002 and 2003. In the second quarter of 2001, in response to weakening product demand and economic conditions, we renegotiated the commitment to extend the payment to 2002. As of June 30, 2001, we had prepaid a total of $5.0 million towards this commitment. At June 30, 2001, the amount was included in other current assets on the balance sheet.

Lease Commitments. We have long-term, non-cancelable building lease commitments. We are currently seeking subtenants for our unused office space. We may be unable to secure subtenants for such space due to the recent decrease in demand for commercial rental space in Silicon Valley. See also "Business Risks -If we are not successful in subleasing our unused office space, we will be required to take a period charge for the difference between the total future sublease income and our lease cost."

We believe that our cash balances, together with funds expected to be generated from operations and the line of credit availability, will be sufficient to meet our projected working capital and other cash requirements through at least the next twelve months. However, 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.

Business Risks

Risks Related to Our Business

Our operating results fluctuate significantly, 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 in 2000 and the six months ended June 30, 2001, we have experienced a sequential decline in net revenues over the past three quarters and our past financial performance should not be used to predict future operating results. In addition, we incurred net losses in fiscal 1997, 1998 and 1999. 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 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;

- o product obsolescence;
- o lower of cost or market inventory adjustments;
- o changes in demand for, or in the mix of, our products;
- o the gain or loss of significant customers;
- o market acceptance of products utilizing our SuperFlash(R)technology;
- o changes in the channels through which our products are distributed and the timeliness of receipt of distributor resale information;
- o exchange rate fluctuations;
- o general economic, political and environmental-related conditions, such as natural disasters;
- o difficulties in forecasting, planning and management of inventory levels;
- o unanticipated research and development expenses associated with new product introductions; and
- o the timing of significant orders and of license and royalty revenue.

As recent experience confirms, a downturn in the market for products such as personal computers and cellular telephones 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 revenue projections. We may experience revenue shortfalls for the following reasons:

- o sudden drops in consumer demand which causes customers to cancel backlog, push out shipment schedules, or reduce new orders, possibly due to a slowing economy or inventory corrections among our customers;

- o significant declines in selling prices that occur because of competitive price pressure during an over-supply market environment;
- o sudden shortages of raw materials or 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
- o the reduction, rescheduling or cancellation of customer orders.

We have a large amount of inventory on hand which could be subject to a potential write down.

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 write down our inventory value to reflect the lower of cost or market. As of June 30, 2001, we had $179.2 million of inventory on hand, a sequential increase of $50.7 million, or 39.4% from March 31, 2001. During the first half of 2001, we have written down a total of $11.8 million of our inventory, $5.9 million of which occurred in the second quarter. Further write downs of 16Mbit and other inventory may occur in the third quarter if projected selling prices deteriorate beyond our expectations. The inventory of the 16Mbit products accounted for approximately 8.1% of total inventory at June 30, 2001. Due to large amount of this inventory, even a small change in average

selling prices could result in a significant write-down and have a significant impact on our financial position and results of operations.

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. We experienced a sharp downturn in several of our markets late in the fourth quarter of 2000, as our customers reacted to weakening demand for their products. The second quarter was another difficult quarter for us due to the excess inventory situation. Our customers have continued to return product, cancel backlog and/or push out shipments. Our business could be harmed by industry-wide fluctuations in the future.

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

During 1998, 1999, 2000 and the six months ended June 30, 2001, our export product and licensing revenues accounted for approximately 92.7%, 89.1%, 84.3%, and 90.5% 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:

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

In addition, we have made equity investments in several companies with operations in Japan, Taiwan and China. The value of our investments is subject to the economic and political conditions particular to their industry, their countries and to 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 80.8%, 77.6%, and 78.4% of our net product revenues from Asia during 1999, 2000, and the six months ended June 30, 2001, respectively. Additionally, our major wafer suppliers and assembly and packaging subcontractors are all 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. For example, during 1997 and 1998, several Asian countries where we do business, such as Japan, Taiwan and Korea, experienced

severe currency fluctuation and economic deflation, which negatively impacted our total revenues and also negatively impacted our ability to collect payments from these customers. During this period, the lack of capital in the financial sectors of these countries made it difficult for our customers to open letters of credit or other financial instruments that are guaranteed by foreign banks.

Finally, the economic situation in this period exacerbated a decline in selling prices for our products as our competitors reduced 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 could delay production or shipment of our products. Any kind of activity of this nature or even rumors of such activity could harm our operations, revenues, operating results, and stock price.

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, and we cannot be certain as to future order levels from our customers. When we do enter into a long-term contract, the contract is generally terminable at the convenience of the customer. An early termination by one of our major customers would harm our financial results as it is unlikely that we would be able to rapidly replace that revenue source.

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, at times, to sell our products. These stocking representatives and distributors could discontinue their relationship with us or discontinue selling our products at any time. Prior to 2001, two of our stocking representatives were responsible for relationships with customers which accounted for substantially all of our product sales in Taiwan, which were 28.3% and 25.5% of our net product revenues during 1999 and 2000. In March 2001, one of our stocking representatives, Professional Computer Technology Limited ("PCT"), established a separate company, Silicon Professional Technology Ltd. ("SPT"), to provide warehousing, logistics and distribution services for us in Taiwan. SPT now services substantially all of our customers in Taiwan. For revenue recognition purposes we treat SPT as a distributor and we defer recognition of the revenue and cost of products shipped to SPT until it has been sold to the end customer. In the first half of 2001, PCT and SPT accounted for 20.9% of revenue recognized during this period. For the entire six months ended June 30, 2001, product sales in Taiwan, which were serviced by four stocking representatives, were 31.8% of our net product revenues. One stocking representative was responsible for relationships with customers which accounted for substantially all of our sales in China, including Hong Kong, during 1999 and 2000, which accounted for 24.3%, 19.1%, and 15.4% of our total net product revenues during 1999, 2000 and the six months ended June 30, 2001, respectively.

Product sales to our top 10 accounts, which comprise OEM end customers, stocking representatives and distributors represented approximately 62.8%, 53.6%, 43.0%, and 60.5% of our net product revenues for 1998, 1999, 2000 and the six months ended June 30, 2001, respectively. During 2000, 7 of our top 10 accounts were stocking representatives, two were domestic distributors and one was an OEM. No single customer account represented 10.0% or more of product revenues during 2000. In 1998, one customer account represented 15.2% of product sales. Another customer account represented 10.7% and 12.4% of product sales in 1998 and 1999, respectively.

The loss of our relationship with any of these stocking representatives or distributors or any other significant stocking representative or distributor could harm our operating results by impairing our ability to sell our products

to these customers.

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 all of our manufacturing with the exception of limited testing activities. We currently buy all of our wafers and sorted die from a limited number of suppliers. Substantially all of our products are manufactured by four foundries, Taiwan Semiconductor Manufacturing Co., Ltd., in Taiwan, Sanyo Electric Co., Ltd., in Japan, Seiko-Epson Corp. in Japan, and Samsung Electronics Ltd. in Korea. We anticipate that these foundries, together with National Semiconductor Corporation in the United States, Nanya Technology Corporation and Vanguard International Semiconductor Corporation in Taiwan, and OKI Electric Industry Co. in Japan will manufacture the majority of our products in the second half of 2001 and into 2002. On March 6, 2001, we invested $50.0 million in Grace Semiconductor Manufacturing Corporation (GSMC), a Cayman Islands company, for a wafer foundry project located in Shanghai, P.R.C. If these suppliers fail to satisfy our requirements on a timely basis and 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 new product production and could experience these delays in the future. We are also subject to the risks of service disruptions, raw material shortages and price increases by the foundries. Such disruptions, shortages and price increases could harm our operating results.

If we are unable to increase our manufacturing capacity, our revenues may decline.

In order to grow, we need to increase our present manufacturing capacity. Events that we have not foreseen could arise which would limit our capacity. We have a remaining commitment to prepay a total of $45.0 million in 2001 and 2002, subject to certain economic and business conditions, to secure increased wafer capacity in 2002 and 2003. We are continually engaged in attempting to secure additional manufacturing capacity to support our long-term growth. Similar to our $50.0 million 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.

If we are not successful in subleasing our unused office space, we will be required to take a period charge for the difference between the total future sublease income and our lease cost.

We have long-term, non-cancelable building lease commitments. We are currently in the process of locating subtenants for our unused office space. We may be unable to secure subtenants for this space due to the recent decrease in demand for commerical rental space in Silicon Valley. If we are unable to secure subtenants, or if the rental values in Silicon Valley decrease such that even if we found subtenants we would still be obligated to pay a portion of the rent, we

will be required to take a period charge for the difference between the total future sublease income and our lease cost, and this will harm our operating results.

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 sometimes have 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 foreign 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 would 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. Each 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 products supplied to us;

o potential increases in prices due to capacity shortages and other factors; and
o 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 six 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 memory products, which presently account for substantially all of our revenues, compete principally against products offered by Intel, Advanced Micro Devices, Atmel, STMicroelectronics, Sanyo, Winbond Electronics and Macronix. If we are successful in developing our high density products, these products will compete principally with products offered by Intel, Advanced Micro Devices, Fujitsu, Hitachi, Sharp, Samsung Semiconductor, SanDisk and Toshiba, as well as any new entrants to the market.

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, or FRAM, 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:

o rapidly changing technologies;
o evolving and competing industry standards;
o changing customer needs;
o frequent new product introductions and enhancements;
o increased integration with other functions; and
o 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 is 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 will depend, 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. We own 37 patents in the United States relating to our products and processes, and have filed for several more. In addition, we hold several patents in Europe and Canada, and have filed several foreign patent applications in Europe, Japan, Korea, Taiwan and Canada.

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.

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.

Over the past three years we were sued both by Atmel Corporation and Intel Corporation regarding patent infringement issues and sued Winbond Electronics Corporation regarding our contractual relationship with them. Significant management time and financial resources have been devoted to defending these lawsuits. We settled with Intel in May 1999, with Winbond in October 2000, and the Atmel litigation is ongoing.

In addition to the Atmel, Intel and Winbond 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 all 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 could 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, 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.

Public announcements may hurt our stock price. During the course of 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.

Our litigation may be expensive, may be protracted and confidential information may be compromised. Whether or not we are successful in our lawsuit with Atmel, we expect this litigation to consume substantial amounts of our financial and managerial resources. At any time Atmel may file additional claims against us, which could increase the risk, expense and duration of the litigation. Further, because of the substantial 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.

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 near one or more of our major suppliers, like the one that occurred in Taiwan in September 1999, could disrupt the operations of those suppliers, which could limit the supply of our products and harm our business.

Prolonged electrical power outages or 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 currently susceptible to power outages and shortages as well as increased energy costs. To limit this exposure, we are in the process of securing back-up generators and power supplies to our main California facilities. 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 continues to place a significant strain on our management systems and resources and if we fail to manage our growth, our ability to market and sell our products and develop new products may he harmed.

Our business is experiencing rapid growth which has strained our internal systems and will require us to continuously develop sophisticated information management systems in order to manage the business effectively. We are currently implementing a supply-chain management system and a vendor electronic data interface system. There is no guarantee that we will be able to

24

implement these new systems in a timely fashion, that in themselves they will be adequate to address our expected 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.

Risks Related to Our Industry

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

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 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 wide

fluctuations in product supply and demand. From time to time, the industry has also experienced significant downturns, often in connection with, or in anticipation of, maturing product cycles and declines in general economic conditions. Downturns of this type occurred in 1997 and 1998, and we are currently experiencing such a downturn. These downturns are characterized by diminished product demand, production over-capacity and accelerated decline of average selling prices, and in some cases have lasted for more than a year. Our business could be harmed by industry-wide fluctuations in the future. The flash memory products portion of the semiconductor industry, from which we derive substantially all of our revenues suffered from excess capacity in 1996, 1997, and 1998, which resulted in greater than normal declines in our markets, which unfavorably impacted our revenues, gross margins and profitability. While these conditions improved in 1999 and 2000, deteriorating market conditions at the end of 2000 and the first half of 2001 have resulted in the decline of our selling prices and harmed operating results.

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 1999 and the first half of 2000, this seasonality was partially offset by the introduction of new products as we continued to diversify our product offerings. However, in the first quarter of 2001, this seasonality again became pronounced as it was combined with deteriorating market conditions, which together resulted in a decline in product revenues from the fourth quarter of 2000 to the first half of 2001. 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 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. 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 Japan, Taiwan or China 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 would write off, or expense, some or all of our investments. As of June 30, 2001 the cost of our equity investments in companies with operations in Japan, Taiwan and China was approximately $0.9 million, $20.5 million, and $50.0 million, respectively.

At any time, fluctuations in interest rates could effect interest earnings on our cash, cash equivalents and short-term investments, any interest expense owed on the line of credit facility, or the fair value of our investment portfolio. We believe that the effect, if any, of reasonably possible near term changes in interest rates on our financial position, results of operations,

and cash flows would not be material. Currently, we do not hedge these interest rate exposures. As of June 30, 2001, the carrying value of our marketable securities approximated fair value. The table below presents the carrying value and related weighted average interest rates for our cash, cash equivalents,

restricted cash and available-for-sale investments as of June 30, 2001.

	Carrying Value	Interest Rate
Investment securities:		
Short-term investments - fixed rate	$ 121,648	4.5%
Long-term investments - fixed rate	10,129	3.3%
Total investment securities	131,777	4.4%
Cash, cash equivalents and restricted cash - variable rate	23,404	1.5%
	$ 155,181	3.9%

PART II

Item 1. Legal Proceedings

On January 3, 1996, Atmel Corporation sued us in the U.S. District Court for the Northern District of California. Atmel's complaint alleged that we willfully infringe five U.S. patents owned by or exclusively licensed to Atmel. Atmel later amended its complaint to allege infringement of a sixth patent. Regarding each of these six patents, Atmel sought a judgment that we infringe the patent, an injunction prohibiting future infringement, and treble damages, as well as attorney's fees and expenses.

On two of the six patents, the District Court ruled by summary judgment that we did not infringe. Two of the other patents were invalidated by another U.S. District Court in a proceeding to which we were not a party, but this decision was later reversed by the Federal Circuit Court of Appeals. Thus, four patents remain at issue in Atmel's District Court case against us.

On February 17, 1997, Atmel filed an action with the International Trade Commission, or ITC, against two suppliers of our parts, involving four of the six patents that Atmel alleged that we infringed in the District Court case above. We intervened as a party to that investigation. Pursuant to indemnification agreements with these suppliers, we were obligated to indemnify both to the extent provided in those agreements. As more fully described below, the settlement with Winbond terminated our indemnity obligations to that company.

As to one of these four patents, Atmel's claims were withdrawn because of the summary judgment granted by the District Court, as described above. The administrative law judge, or ALJ, who makes recommended determinations to the ITC, ruled that we did not infringe the remaining three patents. As to one of these patents, U.S. Patent No. 4,451,903 ("the `903 patent," also known as "Silicon Signature"), the ALJ ruled on May 17, 2000 that it is invalid and unenforceable because the patent did not name the proper inventors and because Atmel intentionally misled the U.S. Patent Office. On October 16, 2000, the ITC overturned the ALJ's recommendation on the `903 patent and ruled that we could not import into the United States certain products that use this circuit. We

appealed the ITC ruling and in January 2001 the Federal Circuit Court issued an order upholding the ITC's decision, but has not yet issued a written opinion setting forth the basis of that order. The Limited Exclusion order expires September 14, 2001. The ITC also ruled that we do not infringe the two other patents at issue ("the `811 and `829" patents). Atmel appealed that determination but dropped the appeal. On May 8, 2001, we filed a motion with the Commission to terminate the Limited Exclusion Order based on newly discovered evidence. The motion is pending and we do not know when, and what, the Commission's response will be.

In April, 2001, Atmel filed motions for summary judgment on the `811 and `829 patents as well as the `903 patent. On May 11, 2001 we filed our opposition papers with the court and filed motions for summary judgment that the `903 patent is invalid. The trial court denied Atmel's motion for summary judgment and our motion for summary judgment. We currently have two motions for sanctions pending before the trial court based on various discovery abuses by Atmel. The motions were argued July 27, 2001, and have been submitted. The motions for sanctions were granted in part and denied in part. The trial court set the trial date on all issues for January 22, 2002.

On October 1, 2000, we announced a settlement in our lawsuit with Winbond Electronics of Taiwan. We filed a lawsuit against Winbond in July 1998 in the U.S. District Court in San Jose, California pursuant to the termination of our SuperFlash technology licensing agreement with Winbond. As part of the settlement, Winbond agreed to a consent judgment and will not contest the validity and appropriateness of SST's termination of the licensing agreement in June 1998. This settlement concludes all litigation between us and Winbond. We received $10.4 million and $10.0 million in license fees during 2000 and for the six months ended June 30, 2001, respectively, as part of this settlement.

From time to time, we are also involved in other legal actions arising in the ordinary course of business. While we have accrued certain amounts for the estimated legal costs associated with defending these matters, there can be no assurance the Atmel complaint 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.

Item 4. Submission of Matters to a Vote of Security Holders.

Our Annual Meeting of Shareholders was held on June 22, 2001. At the Annual Meeting, the shareholders:

1. elected the persons listed below to serve as a director of the company for the ensuing year and until their successors are elected,

2. approved the 1995 Equity Incentive Plan, as amended, to increase the aggregate number of shares of Common Stock authorized for issuance under such plan by 2,000,000 to 28,250,000 shares, and

3. ratified the selection of PricewaterhouseCoopers LLP as our independent accountants for the fiscal year ending December 31, 2001.

On May 11, 2001, the record date of the Annual Meeting, we had 90,937,015 shares of Common Stock outstanding. At the Annual Meeting, holders of 80,428,276 shares of Common Stock were present in person or represented by proxy. The following

sets forth information regarding the results of the voting at the Annual Meeting.

Proposal 1 - Election of Directors

Director	Votes in Favor	Votes Against	Abstentions
Bing Yeh	77,137,466	0	3,290,810
Yaw Wen Hu	77,933,166	0	2,495,110
Tsuyoshi Taira	79,804,014	0	624,262
Yasushi Chikagami	76,300,365	0	4,127,911
Ronald Chwang	79,012,914	0	1,415,362

Proposal 2 - Approval of the 1995 Employee Incentive Plan, as Amended

Votes in Favor	69,294,691
Votes Against	10,936,155
Abstentions	197,430

Proposal 3 -- Ratification of Selection of Independent Accountant

Votes in Favor	80,033,109
Votes Against	324,491
Abstentions	70,676

Item 6. Exhibits and Reports on Form 8-K.

(a) Exhibits. We incorporate by reference all exhibits filed in connection with our annual report on Form 10-K, as amended, for the year ended December 31, 2000.

(b) Reports on Form 8-K filed during the quarter ended June 30, 2001: None.

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 14th day of August, 2001.

SILICON STORAGE TECHNOLOGY, INC.

By:

/s/ BING YEH

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

/s/ JEFFREY L. GARON

Jeffrey L. Garon
Vice President Finance & Administration,
Chief Financial Officer and Secretary
(Principal Financial and Accounting Officer)