SILICON STORAGE TECHNOLOGY INC
Form 10-Q/A
January 04, 2002

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

FORM 10-Q/A

[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 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 Registrant as Specified in its Charter)

California	**77-0225590**
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification Number)

1171 Sonora Court
Sunnyvale, California 94086
(Address of Principal Executive Offices including Zip Code)

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file 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, October 31, 2001: 91,371,956

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Part I -- FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

SILICON STORAGE TECHNOLOGY, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share data)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2000	2001	2000	2001
	(unaudited)	(unaudited)	(unaudited)	(unaudited)
Net revenues:				
Product revenues - unrelated parties	$ 146,478	$ 39,368	$ 294,454	139,290
Product revenues - related parties	15,887	25,795	31,800	58,699
License revenues	1,356	9,034	2,967	25,221
Total net revenues	163,721	74,197	329,221	223,210
Cost of revenues	90,086	92,239	183,645	187,634
Gross profit (loss)	73,635	(18,042)	145,576	35,576
Operating expenses:				
Research and development	11,989	13,588	29,246	38,299
Sales and marketing	8,558	7,098	19,061	19,621
General and administrative	3,866	4,548	10,185	14,993
Other	--	756	--	756
Total operating expenses	24,413	25,990	58,492	73,669
Income (loss) from operations	49,222	(44,032)	87,084	(38,093)
Interest and other income	3,197	1,398	6,297	6,244
Interest expense	(66)	(79)	(611)	(265)
Income (loss) before provision for (benefit from) income taxes	52,353	(42,713)	92,770	(32,114)
Provision for (benefit from) income taxes	16,087	(16,231)	24,324	(12,203)
Net income (loss)	$ 36,266	$ (26,482)	$ 68,446	$ (19,911)

Net income (loss) per share - basic	$ 0.41	$ (0.29)	$ 0.81	$ (0.22)
Shares used in per share calculation	89,471	91,208	84,843	90,954
Net income (loss) per share - diluted	$ 0.37	$ (0.29)	$ 0.74	$ (0.22)
Shares used in per share calculation	97,563	91,208	92,818	90,954

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

SILICON STORAGE TECHNOLOGY, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands)

	December 31, 2000	September 30, 2001
	(unaudited)	(unaudited)
ASSETS		
Current assets:		
Cash and cash equivalents	$ 109,086	$ 55,643
Short-term available-for-sale investments	139,963	76,206
Trade accounts receivable-unrelated parties, net	106,258	30,259
Trade accounts receivable-related parties, net	20,000	28,981
Inventories	73,290	136,217
Deferred tax asset	9,491	23,755
Other current assets	14,835	16,271
Total current assets	472,923	367,332
Equipment, furniture and fixtures, net	16,874	23,290
Equity investments	19,369	71,427
Other assets	3,424	4,972
Total assets	$ 512,590	$ 467,021
LIABILITIES		
Current liabilities:		
Notes payable, current portion	$ --	$ 307
Trade accounts payable-unrelated parties	39,184	27,136
Trade accounts payable-related parties	7,339	4,862
Accrued expenses and other liabilities	33,879	18,671
Deferred revenue-unrelated parties	15,274	6,969
Deferred revenue-related parties	--	6,766

Total current liabilities	95,676	64,711
Other liabilities	279	1,970
Total liabilities	95,955	66,681
SHAREHOLDERS' EQUITY		
Common stock	330,310	333,756
Accumulated other comprehensive income	132	302
Retained earnings	86,193	66,282
Total shareholders' equity	416,635	400,340
Total liabilities and shareholders' equity	$ 512,590	$ 467,021

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

SILICON STORAGE TECHNOLOGY, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)

	Nine Months Ended September 30,	
	2000	2001
	(unaudited)	(unaudited)
Cash flows from operating activities:		
Net income (loss)	$ 68,446	$ (19,911)
Adjustments to reconcile net income (net loss) to net cash provided by (used in) operating activities:		
Depreciation/amortization	4,556	7,156
Provision for doubtful accounts receivable	326	2,692
Provision for excess and obsolete inventories and lower of cost or market	4,261	56,281
Other operating expenses	--	756
Deferred income taxes	(2,293)	(14,264)
Tax benefit from employee stock plans	10,954	--
(Gain) loss on sale of equipment	(62)	29
Changes in operating assets and liabilities:		
Accounts receivable-unrelated parties	(78,016)	73,489
Accounts receivable-related parties	(4,665)	(9,163)
Inventories	(31,592)	(119,208)
Other current and noncurrent assets	(5,170)	(1,017)
Trade accounts payable-unrelated parties	19,577	(12,048)
Trade accounts payable-related parties	4,724	(2,477)
Accrued expenses and other current liabilities	24,030	(15,443)
Deferred revenue-unrelated parties	8,391	(8,305)

Deferred revenue-related parties	--	6,766
Net cash provided by (used in) operating activities	23,467	(54,667)
Cash flows from investing activities:		
Restricted cash	--	(12,490)
Repayment of restricted cash	--	12,490
Investment in equity securities	(17,089)	(52,058)
Acquisition of equipment, furniture and fixtures	(7,008)	(12,568)
Proceeds from sale of property and equipment	62	--
Purchases of available-for-sale investments	(133,461)	(57,359)
Sales and maturities of available-for-sale investments	2,546	118,286
Net cash used in investing activities	(154,950)	(3,699)
Cash flows from financing activities:		
Borrowings	39,750	1,800
Repayments	(59,037)	(187)
Issuance of shares of common stock	257,136	3,446
Other	(124)	(136)
Net cash provided by financing activities	237,725	4,923
Net increase (decrease) in cash and cash equivalents	106,242	(53,443)
Cash and cash equivalents at beginning of period	1,223	109,086
Cash and cash equivalents at end of period	$ 107,465	$ 55,643
Supplemental Disclosure of Cash Flow Information:		
Cash received during the period for interest	$ 2,728	$ 7,750
Cash paid during the period for interest	$ 611	$ 283
Cash paid during the period for income taxes	$ 2,413	$ 13,412

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

SILICON STORAGE TECHNOLOGY, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS AT SEPTEMBER 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 and the three and six months ended June 30, 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.

In October 2001, the FASB issued SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." SFAS No. 144 supersedes SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of." SFAS No. 144 applies to all long-lived assets (including discontinued operations) and consequently amends Accounting Principles Board Opinion No. 30, "Reporting the Results of Operations -- Reporting the Effects of Disposal of a Division of a Business." SFAS No. 144 develops one accounting model for long-lived assets that are to be disposed of by sale and requires the measurement to be at the lower of book value or fair value less cost to sell. Additionally, SFAS No. 144 expands the scope of discontinued operations to include all components of an entity with operations that (1) can be distinguished from the rest of the entity and (2) will be eliminated from the ongoing operations of the entity in a disposal transaction. SFAS No. 144 is effective for fiscal years beginning after December 15, 2001. We believe the adoption of SFAS No. 144 will not have a significant impact on our financial statements.

2. Other Operating Expense

During the third quarter of 2001, we recorded a period charge to other operating expense of approximately $756,000 relating to an operating lease for an abandoned building. This charge represents the estimated difference between the total non-discounted future sublease income and our non-discounted lease commitments relating to this building. The charge is an estimate as of September 30, 2001 and may be adjusted if we obtain a sublease for the building and the actual sublease income is significantly different from the estimate.

3. Computation of Net Income (Loss) Per Share

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2000	2001	2000	2001
Numerator - Basic				
Net income (loss)	$ 36,266	$ (26,482)	$ 68,446	$ (19,911)
Denominator - Basic				
Weighted average common stock outstanding	89,471	91,208	84,843	90,954
Basic net income (loss) per share	$ 0.41	$ (0.29)	$ 0.81	$ (0.22)
Numerator - Diluted				
Net income (loss)	$ 36,266	$ (26,482)	$ 68,446	$ (19,911)
Denominator - Diluted				
Weighted average common stock outstanding	89,471	91,208	84,843	90,954
Dilutive potential of common stock equivalents:				
Options	8,092	--	7,975	--
	97,563	91,208	92,818	90,954
Diluted net income (loss) per share	$ 0.37	$ (0.29)	$ 0.74	$ (0.22)

Anti-dilutive stock options to purchase approximately 86,000 shares of common stock were excluded from the computation of diluted net income per share for the nine months ended September 30, 2000 because the exercise price of these options exceeded the average fair market value of our common stock for the nine months ended September 30, 2000. Stock options to purchase approximately 10,309,000 shares of common stock were outstanding as of September 30, 2001. These stock options were not included in the computation of diluted net loss per share for the three and nine months ended September 30, 2001 because we had a net loss for these periods.

4. 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 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 nine months ended September 30, 2001 were not material.

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

	Amortized Cost	Unrealized Gain	Fair Value
Corporate bonds and notes	$ 62,507	$ 139	$ 62,646
Government bonds and notes	59,818	348	60,166
Total bonds and notes	$ 122,325	$ 487	122,812
Less amounts classified as cash equivalents			(46,606)
Total short-term marketable securities			$ 76,206

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

5. Balance Sheet Detail

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

	December 31, 2000	September 30, 2001
Trade accounts receivable-unrelated parties	$ 107,041	$ 33,552
Less allowance for doubtful accounts-unrelated parties	(783)	(3,293)
Trade accounts receivable-related parties	20,000	29,163
Less allowance for doubtful accounts-related parties	--	(182)
	$ 126,258	$ 59,240

	December 31, 2000	September 30, 2001
Raw materials	$ 29,025	$ 98,395
Work in process	17,631	8,227
Finished goods	26,634	29,595
	$ 73,290	$ 136,217

Inventories are stated at the lower of cost (determined on a first-in, first-out basis) or market value. We typically plan our production and inventory levels based on internal forecasts of customer demand, which are highly unpredictable and can fluctuate substantially. The value of our inventory is dependent on our estimate of future average selling prices, and, if our projected average selling prices are over estimated, we may be required to adjust our inventory value 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.

In the third quarter of 2001, we incurred a $42.7 million inventory valuation adjustment to cost of sales comprised of $17.6 million relating to lower of cost or market and replacement valuation adjustments and $25.1 million relating to potential obsolescence allowances. For the nine months ended September 30, 2001, inventory valuation adjustments to cost of sales amounted to $54.5 million.

	December 31, 2000	September 30, 2001
Equipment	$ 13,389	$ 14,778
Design hardware	4,234	6,695
Software	5,781	7,302
Furniture and fixtures	2,269	9,918
	25,673	38,693
Less accumulated depreciation	9,906	15,905
	15,767	22,788
Construction in progress	1,107	502
	$ 16,874	$ 23,290

	December 31, 2000	September 30, 2001
Accrued compensation and related items	$ 14,509	$ 4,050
Accrued income tax payable	11,292	--
Accrued liabilities-related parties	356	1,858
Accrued warranty	357	3,503
Other accrued liabilities	7,365	9,260
	$ 33,879	$ 18,671

6. Shareholders' Equity

In September 2001, our board of directors authorized the purchase of an aggregate of up to $15.0 million of our common stock. The purchases may be made in the open market at prevailing market prices or in negotiated transactions off the market, subject to compliance with applicable provisions of the California Corporation Code and in accordance with applicable federal and state securities laws and regulations. The stock purchase program will continue until September 30, 2002 unless earlier revoked by the board of directors. As of September 30, 2001, no shares had been purchased under this program.

7. 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 September 30, 2001, we had prepaid a total of $5.0 million towards this commitment. At September 30, 2001, the amount was included in other current assets on the balance sheet.

8. 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. A final decision affirming the Limited Exclusion Order was issued in August 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 Commission did not act on our motion and it became moot when the Limited Exclusion Order expired on September 14, 2001.

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. After the decision of the Federal Circuit was rendered, we renoticed our motion for Summary Judgment that the '903 patent was invalid. We also filed two motions for sanctions for alleged discovery abuse. The trial court granted one of our sanctions motions and denied the other. Our motion for Summary Judgment to invalidate the '903 has been submitted and no decision has been reached. Atmel has filed a counter motion for summary Judgment that the '903 patent is valid. We anticipate that the court will issue a ruling on both motions by the end of December 2001. 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 $15.0 million in license fees during 2000 and for the nine months ended September 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.

9. Line of Credit

As of September 30, 2001, we had no borrowings on our line of credit. As of September 30, 2001, our line of credit was for $35.0 million. This agreement expires in 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 September 30, 2001, there was approximately $6.5 million outstanding in letters of credit and $3.1 million available under this line. The line bears interest at a rate of the bank's reference rate plus 0.5% (6.5% at September 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 also pay an unused line fee at the annual rate of one quarter of one percent on the unused portion. As of September 30, 2001, we were in compliance with the covenants of this agreement.

10. 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 (in thousands):

	Three Months Ended September 30, 2001		Nine Months Ended September 30, 2001	
	Revenues	Gross Profit (Loss)	Revenues	Gross Profit (Loss)
SMPG	$ 36,164	$ (35,989)	$ 115,908	$ (27,630)
ASPG	25,945	9,655	75,483	37,054
SPG	3,054	(742)	6,598	931
Technology Licensing	9,034	9,034	25,221	25,221
	$ 74,197	$ (18,042)	$ 223,210	$ 35,576

	Three Months Ended September 30, 2000		Nine Months Ended September 30, 2000	
	Revenues	Gross Profit	Revenues	Gross Profit
SMPG	$ 136,337	$ 60,246	$ 292,123	$ 127,426
ASPG	18,177	9,933	22,747	11,418
SPG	7,851	2,100	11,384	3,765
Technology Licensing	1,356	1,356	2,967	2,967
	$ 163,721	$ 73,635	$ 329,221	$ 145,576

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. Comprehensive Income

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2000	2001	2000	2001
Net income (loss)	$ 36,266	$ (26,482)	$ 68,446	$ (19,911)
Other comprehensive income:				
Change in net unrealized gains on investments, net of tax	56	85	56	170
Total comprehensive income (loss)	$ 36,322	$ (26,397)	$ 68,502	$ (19,741)

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

	December 31, 2000	September 30, 2001
Net unrealized gains on investments, net of tax	$ 132	$ 302

12. 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.

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, 1998 and we are currently experiencing such a downturn. 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 first half of 2001, market conditions generally had not improved and our customers continued to return product, cancel backlog and/or push out shipments. In the third quarter of 2001 the rate of product returns from customers slowed and we began to see a positive change in order activities in our products for DVD players, CD-RW drives, PDAs and video games, as well as the continued strong shipment from the second quarter in our products for desktop PCs and graphics cards. The networking and wireless communications market segments continue to be very weak. Our business could be harmed by industry wide fluctuations in the future.

We derived 80.1% and 79.6% of our net product revenues during the nine months ended September 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. For the nine months ended September 30, 2001, PCT and SPT accounted for 26.0% of net product revenues 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 September 30, 2001

Net Revenues

Net revenues were $74.2 million for the third quarter of 2001 as compared to $62.7 million in the second quarter of 2001 and $163.7 million for the third quarter of 2000. Revenues decreased compared to the third quarter of last year due to decreased shipment volume of our products and due to decreased average selling prices. Revenues for the third quarter of 2001 increased compared to the prior quarter due to an increase in volume of units shipped as a result of improvement in order activities beginning in the middle of the quarter. 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 $223.2 million for the nine months ended September 30, 2001 as compared to $329.2 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 $65.2 million in the third quarter of 2001 as compared to $52.9 million in the second quarter of 2001 and $162.4 million for the third quarter of 2000. Product revenues decreased compared to the third quarter of last year due to decreased shipment volume of our products and due to decreased average selling prices. Product revenues increased compared to the second quarter due to the higher volume of units shipped in the third quarter of 2001. Product revenues decreased to $198.0 million in the first nine months of 2001 from $326.3 million in the first nine months of 2000 due to decreased shipment volume and decreased average selling prices 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 $9.0 million in the third quarter of 2001, as compared to $9.8 million in the second quarter of 2001 and $1.4 million in the third quarter of 2000. The increase from the third quarter of 2000 to the third quarter of 2001 was primarily due to $5.0 million in license fees received as part of our legal settlement with Winbond. The decrease from the second quarter of 2001 to the third quarter of 2001 was primarily due to fluctuation in royalty payments received from our licensees. We anticipate an additional $5.0 million to be paid under the Winbond settlement in the fourth quarter of 2001. Revenues from license fees and royalties increased to $25.2 million for the nine months ended September 30, 2001 from $3.0 million for the comparable period in 2000. The period to period increase was primarily due to $15.0 million in license fees received as part of our legal settlement with Winbond and increases in royalty payments from our licensees. We anticipate that license revenues may fluctuate significantly in the future.

Gross Profit (Loss)

Gross loss was $18.0 million, or 24.3% of net revenues, in the third quarter of 2001 as compared to gross profit of $24.7 million, or 39.3% of net revenues, in the second quarter of 2001 and $73.6 million, or 45.0% of net revenues, in the third quarter of 2000. The significant decrease to gross loss in the third quarter of 2001 from gross profit when compared to the third quarter of 2000 and the second quarter of 2001 was due primarily to inventory valuation adjustments, decreases in average selling prices and increases in anticipated warranty costs. We incurred a $42.7 million inventory valuation adjustment to cost of sales in the third quarter of 2001, comprised of $17.6 million relating to lower of cost or market and replacement valuation adjustments and $25.1 million relating to potential obsolescence allowances. For the nine months ended September 30, 2001, inventory valuation adjustments to cost of sales amounted to $54.5 million. Product gross margin was negative 41.6% for the third quarter 2001, compared to positive 28.1% for the second quarter of 2001 and 44.5% for the third quarter of 2000. For the nine months ended September 30, 2001, gross profit was $35.6 million, or 15.9% of net revenues, compared to $145.6 million, or 44.2% of net revenues, for the comparable period in 2000. Product gross margin for the nine months ended September 30, 2001 decreased to 5.2% from 43.7% for the same period in 2000. The period to period decrease was primarily due to decreased unit shipments, decreased average selling prices and adjustments 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 $26.0 million, or 35.0% of net revenues, in the third quarter of 2001, compared to $24.2 million, or 38.7% of net revenues, in the second quarter of 2001, and $24.4 million, or 14.9% of net revenues, in the third 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, offset by the lack of profit sharing expense in the third quarter of 2001. The increase from the second quarter 2001 was due primarily to an increase in non-production engineering material expense, an increase in commissions expenses due to increases in revenues and bonus accruals for design win activity and a period charge relating to our building lease, offset by a decrease in the expense related to our doubtful accounts. Operating expenses increased to $73.7 million for the nine months ended September 30, 2001 from $58.5 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, and an increase in legal accruals in connection with the Atmel litigation, offset by the lack of profit sharing expense. 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.

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 $13.6 million, or 18.3% of net revenues, during the third quarter of 2001, as compared to $12.4 million, or 19.8% of net revenues, during the second quarter of 2001 and $12.0 million, or 7.3% of net revenues, during the third quarter of 2000. Research and development expenses increased by 9.4% from the second quarter of 2001and by13.3% from the third quarter of 2000 due primarily to an increase in non-production engineering material expense of $1.8 million and increased expenses related to engineering evaluation and mask costs, depreciation related to purchases of new engineering equipment, engineering headcount and occupancy costs, offset by a decrease in profit sharing expense. For the nine months ended September 30, 2001, research and development expenses increased to $38.3 million from $29.2 million for the comparable period in 2000. The period to period increase was primarily due to an increase in non-production engineering material expense of $1.8 million and increased expenses related to engineering and mask costs, depreciation related to purchases of new engineering equipment, and engineering headcount and occupancy costs, offset by a decrease in profit sharing expense. 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 $7.1 million, or 9.6% of net revenues, in the third quarter of 2001 as compared to $6.2 million, or 9.9% of net revenues, in the second quarter of 2001 and $8.6

million, or 5.2% of net revenues, during the third quarter of 2000. The increase in sales and marketing expenses from the second quarter of 2001 to the third quarter of 2001 was primarily attributable to increased commissions expenses due to increases in revenues and bonus accruals relating to design win activity. Compared to the third quarter of 2000, sales and marketing expenses decreased by $1.5 million, or 17.1%, primarily due to decreased commissions expenses due to lower product revenues for the third quarter of 2001. Sales and marketing expenses for the nine months ended September 30, 2001 were $19.6 million as compared to $19.1 million for the same period in 2000. The period to period increase was primarily due to increased headcount and occupancy cost and increased marketing costs, offset by a decrease in commissions and profit sharing expenses. 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 $4.5 million, or 6.1% of net revenues, in the third quarter of 2001, as compared to $5.6 million, or 9.0% of net revenues, in the second quarter of 2001 and $3.9 million, or 2.4% of net revenues, during the third quarter of 2000. Expenses increased from the third 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. The decrease in general and administrative expenses from the second quarter of 2001 was primarily due to a decrease in our bad debt expense of $2.1 million, offset by an increase in our legal expense related to the Atmel litigation of approximately $873,000. General and administrative expenses for the nine months ended September 30, 2001 were $15.0 million as compared to $10.2 million for the same period in 2000. The period to period increase was due primarily to increased expenses related to our allowance for doubtful accounts and legal expense, offset by a decrease in profit sharing expenses. 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."

Other.

During the third quarter of 2001, we recorded a period charge to other operating expense of approximately $756,000 relating to an operating lease for an abandoned building. This charge represents the estimated difference between the total non-discounted future sublease income and our non-discounted lease commitments relating to this building. The charge is an estimate as of September 30, 2001 and may be adjusted if we obtain a sublease for the building and the actual sublease income is significantly different from the estimate.

Interest and other income.

Interest and other income was approximately $1.4 million, or 1.9% of net revenues, during the third quarter of 2001, as compared to $1.5 million, or 2.3% of net revenues, during the second quarter of 2001 and $3.2 million, or 2.0% of net revenues, during the third quarter of 2000. Interest income decreased from the third quarter of 2000 to the third quarter of 2001 and from the second quarter of 2001 to the third quarter of 2001 due to a decrease in cash, cash equivalents and available-for-sale investments balances. Interest and other income decreased to $6.2 million for the first nine months of 2001 from $6.3 million in the comparable period of 2000.

Interest Expense.

Interest expense was approximately $79,000 for the third quarter of 2001 as compared to $87,000 for the second quarter of 2001 and $66,000 for the third quarter of 2000. Interest expense decreased to $265,000 for the first nine months of 2001 from $611,000 in the first nine months 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 (Benefit from) Income Taxes

Our income tax benefit of $16.2 million in the third quarter of 2001 consists of a 38.0% tax rate on loss before taxes. This compares with a tax provision of $692,000 in the second quarter of 2001 which was a 38.0% tax rate on income before taxes and a tax provision of $16.1 million in the third quarter of 2000 which was a 30.7% tax rate on income before taxes. For the first nine months of 2001, we recorded a benefit from income taxes of $12.2 million, or a 38.0% tax rate on loss before taxes, as compared to $24.3 million, or 26.2% tax rate on income before taxes, for the same period in 2000. 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 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. 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 10 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 44.2% in the third quarter of 2000 to 5.8% in the second quarter of 2001 and to negative 99.5% in the third quarter of 2001 for this segment due to the inventory valuation adjustments to cost of sales during the each of the first three 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, Internet appliances, PDAs, MP3 players, Set-top boxes and other types of mass data storage applications. Gross margin decreased from 55.7% in the second quarter of 2001, and from 54.7% in the third quarter of 2000, to 37.2% in the third quarter of 2001 due to decreased average selling prices and inventory valuation adjustments to cost of sales in the third quarter of 2001.

SPG includes ComboMemory, ROM/RAM Combos, SRAM-related and other special flash products. Gross margin decreased from 26.8% in the third quarter of 2000, and from 59.6% in the second quarter of 2001, to negative 24.3% in the third quarter of 2001 for this segment due to changes in the mix of the types of products sold between the reporting periods and inventory valuation adjustments to cost of sales in the third quarter of 2001.

Revenue and gross profit related to Technology Licensing was $1.4 million for the third quarter of 2000, $9.8 million for the second quarter of 2001 and $9.0 million for the third 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.

In October 2001, the FASB issued SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." SFAS No. 144 supersedes SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of." SFAS No. 144 applies to all long-lived assets (including discontinued operations) and consequently amends Accounting Principles Board Opinion No. 30, "Reporting the Results of Operations -- Reporting the Effects of Disposal of a Division of a Business." SFAS No. 144 develops one accounting model for long-lived assets that are to be disposed of by sale and requires the measurement to be at the lower of book value or fair value less cost to sell. Additionally, SFAS No. 144 expands the scope of discontinued operations to include all components of an entity with operations that (1) can be distinguished from the rest of the entity and (2) will be eliminated from the ongoing operations of the entity in a disposal transaction. SFAS No. 144 is effective for fiscal years beginning after December 15, 2001. We believe the adoption of SFAS No. 144 will not have a significant impact on our financial statements.

Liquidity and Capital Resources

Operating activities.

Our operating activities used cash of $54.7 million for the nine months ended September 30, 2001 as compared to generating cash of $23.5 million for the nine months ended September 30, 2000. The cash used by operating activities for the nine months ended September 30, 2001 related primarily to net loss of $19.9 million, increases in inventory of $119.2 million, accounts receivable-related parties of $9.2 million, deferred income taxes of $14.3 million and other assets of $1.0 million and decreases in trade accounts payable from related and unrelated parties of $14.5 million, accrued expenses of $15.4 million and deferred revenue-unrelated parties of $8.3 million. Cash used in operating activities was reduced by a decrease of $73.5 million in trade accounts receivable-unrelated parties, an increase of

$6.8 million in deferred revenue-related parties and non-cash adjustments of $66.9 million, primarily relating to inventory valuation adjustments of $56.3 million, depreciation and amortization, increased provisions for doubtful accounts receivable and other operating expenses. Decreased accounts receivable-unrelated parties relates to decreased shipment volume and decreased average selling prices. Increased accounts receivable-related parties and increased deferred revenue-related parties relate to a new distribution relationship with a company owned by one of the companies in which we have an equity investment. The cash provided by operating activities for the nine months ended September 30, 2000 related primarily to net income of $68.5 million, tax benefits from employee stock plans of $11.0 million, non-cash adjustments of $9.2 million and increases in trade accounts payable from related and unrelated parties of $24.3 million, accrued expenses and deferred revenue of $32.4 million. Increases in trade accounts receivable from related and unrelated parties of $82.7 million, increases in inventory of $31.6 million and increases in other assets of $5.2 million mostly offset the cash provided from operating activities.

Investing activities.

Our investing activities used cash of $3.7 million for the nine months ended September 30, 2001, as compared to using cash of $155.0 million for the first nine 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 our market presence into China. In the second quarter of 2001, we invested an additional $2.1 million in a production subcontractor. In comparison, for the nine months ended September 30, 2000, we made strategic equity investments in our subcontractors totaling $17.1 million. Capital expenditures were $12.6 million for the current nine month period as compared to $7.0 million in capital expenditures for the same period of 2000. The expenditures for the nine months ended September 30, 2001 include $6.0 million of leasehold improvements on new building leases signed in 2000. Cash used in investing activities was reduced by the excess of sales and maturities of available-for-sale investments over the purchases of such investments by $60.9 million in the nine months ended September 30, 2001. For the comparable period in 2000, we used a net of $130.9 million to purchase available-for-sale investments.

Financing activities.

Our financing activities provided cash of approximately $4.9 million during the nine months ended September 30, 2001 as compared to $237.7 million for the nine months ended September 30, 2000. For the current nine month period, the cash provided was from $3.4 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 $323,000 in loan repayments and other. The cash provided for the nine months ended September 30, 2000 was primarily from the issuance of common stock for $257.1 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, offset by the repayment of our entire line of credit at the end of March, 2000.

Principal sources of liquidity at September 30, 2001 consisted of $131.8 million of cash, cash equivalents and short-term available-for-sale investments and the line of credit. As of September 30, 2001 we had no borrowings on our line of credit. As of September 30, 2001, our line of credit was for $35.0 million. This agreement expires in 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 September 30, 2001 there was approximately $6.5 million outstanding in letters of credit and $3.1 million available under this line. The line bears interest at a rate of the bank's reference rate plus 0.5% (6.5% at September 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 also pay an unused line fee at the annual rate of one quarter of one percent on the unused portion. As of September 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 September 30, 2001, we had prepaid a total of $5.0 million towards this commitment. At September 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. During the third quarter of 2001, we recorded a period charge to other operating expense of approximately $756,000 relating to an operating lease for an abandoned building. This charge represents the estimated difference between the total non-discounted future sublease income and our non-discounted lease commitments relating to this building. The charge is an estimate as of September 30, 2001 and may be adjusted if we obtain a sublease for the building and the actual sublease income is significantly different from the estimate. 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 may be required to take a period charge for the difference between the total future sublease income and our lease cost."

Stock Purchase Plan.

In September 2001, our board of directors authorized the purchase of an aggregate of up to $15.0 million of our common stock. The purchases may be made in the open market at prevailing market prices or in negotiated transactions off the market, subject to compliance with applicable provisions of the California Corporation Code and in accordance with applicable federal and state securities laws and regulations. The stock purchase program will continue until September 30, 2002 unless earlier revoked by the board of directors. As of September 30, 2001, no shares had been purchased under this program.

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, we incurred net losses for the nine months ended September 30, 2001, and in fiscal 1997, 1998 and 1999. Our operating results have fluctuated significantly and our past financial performance should not be used to predict future operating results. Our recent quarterly and annual operating results have fluctuated, and may continue to fluctuate, due to the following factors, all of which are difficult to forecast and many of which are out of our control:

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

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

As recent experience confirms, a downturn in the market for 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:

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

During 2001 we have incurred inventory valuation adjustments of $54.5 million and we may incur additional significant inventory valuation adjustments in future periods.

We typically plan our production and inventory levels based on internal forecasts of customer demand, which are highly unpredictable and can fluctuate substantially. The value of our inventory is dependent on our estimate of future average selling prices, and, if our projected average selling prices are over estimated, we may be required to adjust our inventory value to reflect the lower of cost or market. As of September 30, 2001, we had $136.2 million of inventory on hand, a sequential decrease of $43.0 million, or 24.0% from June 30, 2001. During the first half of 2001, we had incurred a total valuation adjustment of $11.8 million to our inventory, and in the third quarter of 2001 we incurred further inventory valuation adjustments of $42.7 million. Due to the large amount of our inventory, even a small change in average selling prices could result in a significant adjustment 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. Although we had improvements in both total units shipped and revenues in the third quarter of 2001, it continued to be a difficult quarter for us due to the excess inventory situation. 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 1999, 2000 and the nine months ended September 30, 2001, our export product and licensing revenues accounted for approximately 89.1%, 84.3%, and 90.2% of our net revenues, respectively. Our international business activities are subject to a number of risks, each of which could impose unexpected costs on us that would harm our operating results. These risks include:

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

In addition, we have made equity investments in 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 79.6% of our net product revenues from Asia during 1999, 2000, and the nine months ended September 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. Additionally, we believe the economic uncertainty fueled by the September 11, 2001 terrorist attack in the United States has caused our customer base to become more cautious. 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 nine months of 2001, PCT and SPT accounted for 26.0% of net product revenues recognized during this period. For the nine months ended September 30, 2001, product sales in Taiwan, which were serviced by four stocking representatives, were 34.7% 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 16.3% of our total net product revenues during 1999, 2000 and the nine months ended September 30, 2001, respectively.

Product sales to our top 10 accounts, which comprise OEM end customers, stocking representatives and distributors, represented approximately 53.6%, 43.0%, and 62.8% of our net product revenues for 1999, 2000 and the nine months ended September 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 1999 one customer account represented 12.4% of product sales.

The loss of our relationship with any of these stocking representatives or distributor, 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 2001and 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 may 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 commercial rental space in Silicon Valley. During the third quarter of 2001, we recorded a period charge to other operating expense of approximately $756,000 relating to an operating lease for an abandoned building. This charge represents the estimated difference between the total non-discounted future sublease income and our non-discounted lease commitments relating to this building. The charge is an estimate as of September 30, 2001 and may be adjusted if we obtain a sublease for the building and the actual sublease income is significantly different from the estimate. If we are unable to secure subtenants, we may be required to take additional period charges for the total future 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;
- potential increases in prices due to capacity shortages and other factors; and
- potential misappropriation of our intellectual property.

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

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

Due to the flash memory product cycle we usually require more than nine months to realize volume shipments after we first contact a customer. We first work with customers to achieve a design win, which may take three months or longer. Our customers then complete the design, testing and evaluation process and begin to ramp up production, a period which typically lasts an additional 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:

- rapidly changing technologies;
- evolving and competing industry standards;
- changing customer needs;
- frequent new product introductions and enhancements;
- increased integration with other functions; and
- rapid product obsolescence.

To develop new products for our target markets, we must develop, gain access to and use leading technologies in a cost-effective and timely manner and continue to expand our technical and design expertise. In addition, we must have our products designed into our customers' future products and maintain close working relationships with key customers in order to develop new products that meet their changing needs.

In addition, products for communications applications are based on continually evolving industry standards. Our ability to compete will depend on our ability to identify and ensure compliance with these industry standards. As a result, we could be required to invest significant time and effort and incur significant expense to redesign our products and ensure compliance with relevant standards. We believe that products for these applications will encounter intense competition and be highly price sensitive. While we are currently developing and introducing new products for these applications, we cannot assure you that these products will reach the market on time, will satisfactorily address customer needs, will be sold in high volume, or will be sold at profitable margins.

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

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

We are highly dependent on Bing Yeh, our President and Chief Executive Officer, as well as the other principal members of our management team and engineering staff. There is intense competition for qualified personnel in the semiconductor industry, in particular the highly skilled design, applications and test engineers involved in the development of flash memory technology. Competition is especially intense in Silicon Valley, where our corporate headquarters 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 42 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 such as typhoon near one or more of our major suppliers, like the earthquake in September 1999 or the typhoon in September 2001 that occurred in Taiwan, which did not impact us, could potentially disrupt the operations of those suppliers, which could then 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 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 three quarters of 2001 have resulted in the decline of our selling prices and harmed our 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 sequential quarter to quarter declines in product revenues from the fourth quarter of 2000 through the second quarter 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 September 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 September 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 and available-for-sale investments as of September 30, 2001 (in thousands).

	Carrying Value	Interest Rate
Short-term investments - fixed rate	$ 76,206	4.0%
Cash and cash equivalents - variable rate	55,643	2.9%
	$ 131,849	3.5%

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 f