

SILICON STORAGE TECHNOLOGY INC  
Form 10-K  
January 16, 2008

[QuickLinks](#) -- Click here to rapidly navigate through this document

---

---

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

---

**FORM 10-K**

---

(MARK ONE)

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

For the fiscal year ended December 31, 2006

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**

(State or Other Jurisdiction of Incorporation or Organization)

**77-0225590**

(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)

Securities registered pursuant to Section 12(b) of the Act:

**Title of each class**

**Name of each exchange on which registered**

---

Common Stock, no par value

---

The NASDAQ Stock Market LLC  
(NASDAQ Global Market)

Securities registered pursuant to Section 12(g) of the Act: None.

Edgar Filing: SILICON STORAGE TECHNOLOGY INC - Form 10-K

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes  No

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K, or any amendment to this Form 10-K.

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

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

The aggregate market value of the voting stock held by non-affiliates of the registrant as of June 30, 2006 was \$361,634,512 based on the closing price of the registrant's common stock as reported on the NASDAQ Global Market. Shares of the registrant's common stock held by each officer and director and affiliated entities who own 5% or more of the outstanding common stock of the registrant have been excluded in that such persons and entities may be deemed to be affiliates. This determination of affiliate status is not necessarily a conclusive determination for other purposes. This calculation does not exclude shares held by persons or entities whose ownership exceeds 5% of the registrant's common stock that have represented to the registrant that they are registered investment advisers or investment companies registered under section 8 of the Investment Company Act of 1940.

Number of shares outstanding of SST's Common Stock, no par value, as of the latest practicable date December 1, 2007: 104,197,735.

---

---

---

**Silicon Storage Technology, Inc.**  
**Form 10-K**  
**For the Year Ended December 31, 2006**  
**TABLE OF CONTENTS**

		<b>Page</b>
	Explanatory Note Regarding Restatement	3
<b>Part I.</b>		
Item 1.	Business	5
Item 1A.	Risk Factors	12
Item 1B.	Unresolved Staff Comments	26
Item 2.	Properties	26
Item 3.	Legal Proceedings	26
Item 4.	Submission of Matters to a Vote of Security Holders	27
<b>Part II.</b>		
Item 5.	Market for the Registrant's Common Stock, Related Stockholder Matters and Issuer Purchases of Equity Securities	28
Item 6.	Selected Consolidated Financial Data	30
Item 7.	Management's Discussion and Analysis of Financial Condition and Results of Operations	32
Item 7A.	Quantitative and Qualitative Disclosures About Market Risk	57
Item 8.	Financial Statements and Supplementary Data	58
Item 9.	Changes in and Disagreements with Accountants on Accounting and Financial Disclosure	73
Item 9A.	Controls and Procedures	73
Item 9B.	Other Information	77
<b>Part III.</b>		
Item 10.	Directors, Executive Officers and Corporate Governance	78
Item 11.	Executive Compensation	82
Item 12.	Security Ownership of Certain Beneficial Owners and Management and Related Shareholder Matters	95
Item 13.	Certain Relationships and Related Transactions and Director Independence	97
Item 14.	Principal Accountant Fees and Services	99
<b>Part IV.</b>		
Item 15.	Exhibits and Financial Statement Schedules	101
<b>Index to Consolidated Financial Statements</b>		101
<b>Index to Exhibits</b>		101
<b>Signatures</b>		104

**Explanatory Note Regarding Restatement**

In March 2007, the Board of Directors of Silicon Storage Technology, Inc. initiated a voluntary review of our historical stock option grant practices covering the time from our initial public offering in 1995 through 2007. The review was led by the Chairman of the Audit Committee of the Board of Directors with the assistance of outside independent legal counsel, and began on or about March 15, 2007. Based on the results of the review, we have concluded that certain stock options granted during the period January 1, 1997 to December 31, 2005 were not correctly accounted for in accordance with U.S. generally accepted accounting principles, or GAAP, applicable at the time those grants were made. As a result, in this Annual Report on Form 10-K we are restating our historical financial statements to record adjustments for stock-based compensation expense relating to past stock option grants in accordance with Accounting Pronouncement Bulletin No. 25, *Accounting for Stock Issued to Employees*. In addition we have recorded additional adjustments that were previously considered immaterial.

We are also restating the pro forma disclosures for stock-based compensation expense required under Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation*, and Statement of Financial Accounting Standards No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure*.

The effect of the restatement is reflected in the consolidated financial statements, selected consolidated financial data and other financial data, including quarterly data, included in this Annual Report on Form 10-K. For additional information, see Note 2. "Restatement of Consolidated Financial Statements" to our consolidated financial statements. We have also included restated financial information under Item 6. "Selected Consolidated Financial Data" for 2002 through 2005. Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations" includes the income statement impact of the restatements during the period January 1, 1997 to December 31, 2005, and Item 8. "Financial Statements and Supplementary Data - Selected Quarterly Information (Unaudited)," includes restated quarterly financial information for each interim period during 2005 and 2006.

We have not amended any of our other previously filed Annual Reports on Form 10-K for the periods affected by the restatement or our Quarterly Reports on Form 10-Q filed prior to December 31, 2006. For this reason, the consolidated financial statements and related financial information contained in such previously filed reports should no longer be relied upon. Subsequent to the filing of this Annual Report on Form 10-K for the year ended December 31, 2006, we will be filing our Quarterly Reports on Form 10-Q for the three months ended March 31, 2007, June 30, 2007 and September 30, 2007 and investors should read these Quarterly Reports on Form 10-Q for information relating to business, financial results and operations for such periods.

The restatement of our consolidated financial statements, financial data and related disclosures described in this Annual Report on Form 10-K is collectively referred to in this Annual Report on Form 10-K as the "restatement."

## Edgar Filing: SILICON STORAGE TECHNOLOGY INC - Form 10-K

The financial statement impact of the restatement of stock-based compensation expense and related payroll and income taxes, as well as other accounting adjustments, by year, is as follows (in thousands):

Year	Adjustment to Stock-Based Compensation Expense	Adjustment to Payroll Tax Expense (Benefit)	Adjustment to Income Tax Expense (Benefit) Relating to Stock-Based Compensation and Payroll Tax Expense (Benefit)	Adjustment to Stock-Based Compensation Expense (Benefit), Net of Payroll and Income Taxes	Other Adjustments, Net of Income Taxes	Total Restatement Expense (Benefit)
1997	\$ 136	\$ 26	\$ (57)	\$ 105		\$ 105
1998	209	3	(11)	201		201
1999	945	1,987	(40)	2,892		2,892
2000	10,964	7,563	(7,464)	11,063		11,063
2001	8,478	2,796	(4,027)	7,247		7,247
2002	8,297	1,520	(3,832)	5,985	444	6,429
2003	6,809	(1,074)	14,391	20,126	(444)	19,682
Cumulative through December 31, 2003	35,838	12,821	(1,040)	47,619		47,619
2004	2,302	(6,041)		(3,739)	1,012	(2,727)
2005	683	(2,515)		(1,832)	(1,382)	(3,214)
<b>Total</b>	<b>\$ 38,823</b>	<b>\$ 4,265</b>	<b>\$ (1,040)</b>	<b>\$ 42,048</b>	<b>\$ (370)</b>	<b>\$ 41,678</b>

Additionally, we have reviewed the consequences of issuing in-the-money grants under Section 409A of the Internal Revenue Code and adverse tax consequences will result from our revision of accounting measurement dates for stock options that vest subsequent to December 31, 2004. These adverse tax consequences include a penalty tax payable by the option holder under Internal Revenue Code Section 409A and, as applicable, similar penalty taxes under state tax laws. We are considering offering active employees who are option holders the opportunity to amend or exchange their options to avoid the adverse tax consequences of Section 409A.

The Securities and Exchange Commission, or the SEC, may disagree with the manner in which we have accounted for and reported, or not reported, the financial impact of past option grant measurement date errors, and there is a risk that its inquiry could lead to circumstances in which we may have to further restate our prior financial statements, amend prior filings with the SEC, or otherwise take other actions not currently contemplated. In addition, the SEC may issue further guidance on disclosure requirements related to the financial impact of past option grant measurement date errors that may require us to amend this filing or prior filings with the SEC to provide additional disclosures pursuant to such guidance. Any such circumstance could also lead to future delays in filing our subsequent SEC reports and delisting of our common stock from the NASDAQ Global Market.

**PART I**

**Item 1. Business**

**Overview**

Silicon Storage Technology, Inc. (SST, us or we) is a leading supplier of NOR flash memory semiconductor devices for the digital consumer, networking, wireless communications and Internet computing markets. NOR flash memory is a form of nonvolatile memory that allows electronic systems to retain information when the system is turned off. NOR flash memory is used in hundreds of millions of consumer electronics and computing products annually.

We produce and sell many products based on our SuperFlash design and manufacturing process technology. Our products are incorporated into products sold by many well-known companies including Apple, Asustek, BenQ, Cisco, Dell, First International Computer, or FIC, Gigabyte, Haier, Huawei, Infineon, Intel, IBM, Inventec, Legend Lenovo, LG Electronics, Freescale Semiconductor, NEC, Nintendo, Panasonic, Philips, Quanta, Samsung, Sanyo, Seagate, Sony, Sony Ericsson, Toshiba, Texas Instruments, VTEch and ZTE.

We also produce and sell other semiconductor products including smartcards integrated circuits, or ICs, and modules, NAND flash controllers and NAND-controller based modules, radio frequency, or RF, ICs and modules.

We license our SuperFlash technology to leading semiconductor companies including 1<sup>st</sup> Silicon (Malaysia) Sdn. Bhd., Analog Devices, IBM, Freescale Semiconductor, Inc., National Semiconductor Corporation, NEC Corporation, Oki Electric Industry Co., Samsung Electronics Co. Ltd., Sanyo Electric Co., Ltd., or Sanyo, Seiko Epson Corporation, Shanghai Grace Semiconductor Manufacturing Corporation, or Grace, Shanghai Huahong NEC Electronics Co., Ltd., Taiwan Semiconductor Manufacturing Co., Ltd., or TSMC, Toshiba Corporation, Vanguard International Semiconductor Corporation, Powerchip Semiconductor Corporation and Winbond Electronics Corporation for applications in semiconductor devices that integrate flash memory with other functions on a monolithic chip.

We have installed our semiconductor manufacturing processes at several leading wafer foundries and semiconductor manufacturers including Advanced Wireless Semiconductor, Grace, Samsung Electronics Co., Ltd., Sanyo, Seiko Epson Corporation, Shanghai Hua Hong NEC Electronics Co. Ltd., TSMC and Yasu Semiconductor Corporation, or Yasu. These companies produce semiconductor wafers for us that incorporate our process or product intellectual property. These wafers are electrically tested and then subdivided into many small rectangular chips, or die. We work with leading semiconductor assembly and test companies to finish our products by encapsulating and testing them. We are working with Grace, Powerchip Semiconductor Corporation and TSMC, among others, to develop new technology for manufacturing our products.

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

The consumer electronics manufacturing industry is concentrated in Asia. We manufacture virtually all of our products in Asia and we sell most of our products in Asia. We derived 86.0%, 87.6% and 87.7% of our net product revenues during 2004, 2005 and 2006, respectively, from product shipments to Asia.

***Industry Background***

Semiconductor integrated circuits are critical components used in an increasingly wide variety of applications, such as computers and computer systems, communications equipment, consumer products and industrial automation and control systems. As integrated circuit performance has improved and physical size and costs have decreased, the use of semiconductors in many applications has grown significantly.

Historically, the demand for semiconductors has been driven by the PC market. In recent years, growth in demand for semiconductors relating to PCs has been outpaced by growth in demand for semiconductors that are used in digital electronic devices for communication and consumer applications. Communications applications include digital subscriber line modems, cable modems, networking equipment, wireless local area network, or WLAN, devices, cellular phones and Global Positioning Systems, or GPS. Consumer-oriented digital electronic devices include digital cameras, DVD players, MP3 players, personal data assistants, or PDAs, set-top boxes, Digital TVs and video games.

In order to function correctly, PCs and other digital electronic devices require program code. The program code defines how devices function and affects how they are configured. Nonvolatile memory devices were originally used by the personal computer, or PC, industry to provide the BIOS (basic input/output system) to give the PC sufficient information to start up (boot) and to facilitate its access to its high volume nonvolatile memory stored in magnetic media including hard disk drives. In PCs, the code stored in the nonvolatile memory or BIOS, initiates the loading of the PC's operating system, which is then read from the disk drive. In the case of other digital electronic devices, the program code is stored in its entirety in nonvolatile memory, generally flash memory. As a result, virtually every digital electronic system that uses a processor or controller for computing, consumer electronics, communications, and industrial applications requires nonvolatile memory. The predominant forms of nonvolatile memory include Read-Only Memory (ROM), Programmable Read-Only Memory (PROM) and flash memory.

System manufacturers generally prefer nonvolatile memory devices that can be reprogrammed efficiently in the system in order to achieve several important advantages. With reprogrammable memory, manufacturers can cost effectively change program codes in response to faster product cycles and changing market specifications. This in turn greatly simplifies inventory management and manufacturing processes. Reprogrammable memory also allows the manufacturer to reconfigure or update a system either locally or through a network connection. In addition, in-system reprogrammable devices can be used for data storage functions, such as storage of phone numbers for speed dialing in a cellular phone or captured images in a digital camera. Flash memory provides these features better than other forms of nonvolatile memory.

Flash memory is the predominant reprogrammable nonvolatile memory device used to store program code and data. Flash memory can electrically erase select blocks of data on the device much faster and more simply than with alternative solutions, such as Erasable Programmable Read-Only Memory, or EPROM. Moreover, flash memory is significantly less expensive than other re-programmable solutions, such as Electrically Erasable Programmable Read-Only Memory, or EEPROMs. There are two types of flash memories; NOR and NAND, in terms of memory cell array architecture. NOR flash memories are typically used for storing program code and NAND flash memories are typically used for data storage. The rapid growth of flash memory has been fueled by the explosive growth of digital electronic devices that adopted flash memory as the main storage medium for code and data. According to a November 2006 Webfeet Research report, worldwide flash memory revenue was estimated at \$22.9 billion in 2006 and is expected to grow to \$27.0 billion in 2007 and to \$57.4 billion in 2011.

***Our Solution***

We are a leading supplier of NOR flash memory semiconductor devices. We believe our proprietary flash memory technology, SuperFlash, offers superior performance, high reliability and a fast, fixed erase time. We further believe that our SuperFlash technology can be scaled to use the semiconductor industry's most advanced technology nodes and can employ the industry's lowest cost manufacturing processes.

Our NOR flash devices have densities ranging from 256,000 bits (256 Kb) to 64 million bits (64 Mb). These products are generally used to store the instruction set used by the microprocessor or controller in the electronic system product to direct its function. NOR memory can also be used to store mass data in a system, but it is generally less expensive to use NAND memory for this purpose. While NOR memory can be used to store data, NAND memory is generally not useful for the storage of execute-in-place instruction code due to its block data access and existence of defective memory cells that require special error detection and correction management. As a result, electronic systems often use NOR alone or NOR (with RAM, or controller) and NAND together but virtually never NAND memory alone.

***Our Strategy***

Our objective is to become the leading worldwide supplier of NOR flash memory devices, a leading supplier of other semiconductor products in the portable consumer electronics market and the leading licensor of embedded flash technology. We intend to achieve our objectives by:

*Maintaining a leading position in the program code storage market.* We believe that program code storage is an attractive segment of the flash memory market. The number, variety and performance of digital electronic applications continue to increase. Virtually all of these devices need some sort of nonvolatile memory to direct the function of the product's microprocessor or controller. We believe that our proprietary SuperFlash technology is superior because it offers higher reliability and better performance at a lower cost than competing solutions. We regularly introduce additional standard and application specific memory products, including our ComboMemory products. ComboMemory products are used for wireless and portable applications that combine volatile and nonvolatile memory on a single monolithic device or on multiple die in a common package for optimized performance. We are extending our family of serial flash products which offer smaller form factors for manufacturers that are producing ever smaller and more compact consumer devices. In addition, we are continuing to develop versions of our products that consume less power. These lower voltage devices are particularly desirable when applied in battery-powered electronic systems.

*Continuing to enhance our leading flash memory technology.* We believe that our proprietary SuperFlash technology is less complicated, more reliable, more scalable and more cost-effective than competing NOR flash memory technologies. Our ongoing research and development efforts are focused on enhancing our leading flash memory technology by working closely with technology partners who operate wafer fabrication facilities with advanced lithographic and other manufacturing equipment. As consumer electronics companies produce more complex and more compact products, we intend to meet their needs and continue to produce some of the smallest and thinnest semiconductor products. We are also developing and reducing the cost of the associated assembly technologies.

*Leveraging our technology and supply chain to become a premier provider of additional semiconductor products.* Many consumer electronics products incorporate our flash memory products. We are expanding our product line to include additional devices that these manufacturers need for their products. We provide RF power amplifier and transceiver products for wireless applications such as cellular phones, WLAN, Bluetooth, data pagers and cordless telephones. We also provide NAND flash controllers that we believe give electronics systems manufacturers superior flexibility in the design and manufacture of their systems. We also offer a selection of our products in die form. This allows our



customers to develop multi-chip module products for unusual or small form factor products such as Bluetooth earsets and GPS receivers. We also provide multi-chip module products that incorporate die from other semiconductor manufacturers. We intend to continue to develop new products and leverage our supply chain to take advantage of the significant growth opportunities in the wireless applications market with specific focus on cellular phone, GPS, WLAN and Bluetooth applications.

*Maintaining a leading position in licensing embedded flash technology.* We believe that our proprietary SuperFlash technology is well-suited for embedded memory applications, which integrate flash memory and other functions onto a monolithic chip. Many electronic system manufacturers have incorporated our technology into the semiconductor devices that are at the heart of their products. We are expanding our licensing of SuperFlash technology to additional semiconductor wafer foundries at ever finer technology nodes for embedded flash applications to enhance the value of our technology to these electronic system manufacturers. Many digital electronic devices currently being introduced, such as MP3 players, digital cameras and PDAs, require high-density NAND flash memory for storing music, pictures and other data that require large data storage capacities in addition to the NOR memory required to operate the system's controller. We believe that the application market for high-density NAND flash memory is attractive based on its potential size and growth. We are further developing our NAND controllers with embedded NOR flash to address the high-density memory market.

### ***Our Products***

Currently, we offer low to medium density NOR flash devices (256 Kbit to 64 Mbit) and other products that target a broad range of existing and emerging applications in the digital consumer, networking, wireless communications and Internet computing markets. Our products are segmented largely based upon attributes such as density, voltage, access speed, package and target application. We divide our products into two reportable segments: Memory Products and Non-Memory Products.

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

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

### ***Technology Licensing***

We license our SuperFlash technology to semiconductor manufacturers for use in embedded flash applications. We intend to increase our market share by entering into additional license agreements for our SuperFlash process and memory cell technology with leading wafer foundries and semiconductor manufacturers. We expect to continue to receive licensing fees and royalties from these agreements. We design our products using our patented memory cell technology and fabricate them using our patented process technology. As of December 31, 2006, we held 206 patents in the United States relating to certain aspects of our products and processes, with expiration dates ranging from 2010 to 2026 and have filed for several more. In addition, we hold several patents in Europe, Japan, Korea, Taiwan, and China.

### ***Customers***

We provide high-performance flash memory solutions and other products to customers in four major markets: digital consumer, networking, wireless communications and Internet computing. Our customers benefit by obtaining products that we believe are highly reliable, technologically advanced and have attractive cost structures. As a result of these highly desirable benefits, we have developed

## Edgar Filing: SILICON STORAGE TECHNOLOGY INC - Form 10-K

relationships with many of the industry's leading companies. In digital consumer products, we provide products for consumer electronic companies including LG, Hon Hai, Micronas, Apple, Samsung, Lite-On, NEC, Funai, Sony, Orion, BenQ, Sigma Design, ALCO, Inventec, Pioneer, Nintendo, BBK, Toshiba, JVC, Mattel, Panasonic (Matsushita), Sanyo, Konka, Canon, Hisense, Creative, Daewoo, Thomson, Sharp, Reigncom, Olympus, TiVO, and Haier. In networking, we provide products for Broadcom, Atheros, Conexant, Alpha Networks, Gemtek, Gongjin, Hon Hai, Edimax, Avocent, TP-Link, ZTE, Senao, Cameo Communications, Sagem Orga, Adtran, Askey, Intel, Asustek, Global Sun, Thomson, Huawei, TCL, Comtrend, Buffalo, Tecom, Mitsumi, Arris, Cybertan, and Samsung. In wireless communications, we provide products for companies including Syscom, Samsung, Sirf, Crestfounder, USI, GN Netcom, Sagem Orga, Alps, Gemalto, ZTE, Hon Hai, Cambridge Silicon Radio, Watchdata System, Pansun Infotech, Haier, CCT, Wuhan Tienyu Information Industry, Magnificent Mile, Taiyo Yuden, Mitsumi, Ningbo Bird, Logitech, VTech, and Garmin. In Internet computing, we provide a wide array of products for companies including Asustek, Seagate, Western Digital, TPV Technology, Hon Hai, Quanta, Intel, Giga-Byte, Quanta, ECS, Apple, Inventec, Titanic, Lenovo, Matsushita, Sharp, Fujitsu-Siemens, Wistron, Mitac, Microstar, Fujitsu, Epson, Buffalo, Samsung, Brother, USI, Canon, Lite-On, NEC, IBM, and Toshiba.

The following tables illustrate revenue by geographic regions. Revenue by geographic region is determined on where product is shipped by us or our logistics center or where license revenue is generated.

	Year ended December 31,		
	2004	2005	2006
	(Amount in thousands)		
United States	\$ 32,833	\$ 21,261	\$ 24,173
Europe	28,863	32,008	32,381
Japan	35,233	26,455	40,752
Korea	36,715	32,702	30,734
Taiwan	125,491	74,753	97,552
China (including Hong Kong)	148,100	208,658	193,674
Other Asian Countries	41,963	35,062	33,243
	\$ 449,198	\$ 430,899	\$ 452,509

### ***Sales and Distribution***

We sell a majority of our products to customers in Asia through our representatives. We distribute a majority of our products through our logistics center. We also sell and distribute our products in North America and Europe through manufacturers' representatives and distributors. Our manufacturer representative and distributor relationships are generally cancelable, with reasonable notice, by either party.

### ***Backlog***

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 products. Accordingly, the dollar amount associated with 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.

## Edgar Filing: SILICON STORAGE TECHNOLOGY INC - Form 10-K

### *Applications*

As the Digital Consumer, Networking, Wireless Communications and Internet Computing industries continue to expand and diversify; new applications are likely to be developed. We believe our products are designed to address this expanding set of applications:

<b>Digital Consumer</b>		<b>Networking</b>	<b>Wireless Communications</b>	<b>Internet Computing</b>
TV Replayer	Set-top Box	VoIP	Cellular Phone	Information Appliance
Digital TV	CD-ROM Drive	DSL Modem	Data Pager	Notebook PC
Digital Camera	CD-RW Drive	Cable Modem	Cordless Telephone	Desktop PC
Digital Camcorder	DVD-ROM Drive	V.90/56K Modem	GPS on Cellular Phone	Hard Disk Drive
DVD Player	DVD-RAM Drive	Wireless LAN	Bluetooth Applications	LCD Monitor
DVD Recorder	DVD-RW Drive	Network Interface Card	Wireless Modems	Palm PC
VCD Player	Web Browser	Router/Switch		X-PC
MP3 Player	Hand-held GPS			Server
Video Game	Electronic Toys			Graphics Card
PDA	smartcards			Printer
Electronic Book	Memory Cards			Copier/Scanner
Remote Controller	Electronic Organizer			Bar Code Scanner
				Thin Client System

### *Manufacturing*

We purchase wafers and sorted die from semiconductor manufacturing foundries, have these products shipped directly to subcontractors for packaging, testing, and finishing, and then ship the final product to our customers. Virtually all of our subcontractors are located in Asia.

*Wafer and Sorted Die.* During 2006, our major wafer fabrication foundries were TSMC, Grace, Sanyo, HHNEC and Seiko-Epson. In 2006, wafer sort, which is the process of testing individual die on silicon wafer, was performed at King Yuan Electronics Company, Limited, or KYE, Lingsen, HHNEC, Sanyo, Seiko-Epson and TSMC. In order to obtain, on an ongoing basis, an adequate supply of wafers, we have considered and will continue to consider various possible options, including equity investments in foundries in exchange for secure production volumes, the formation of joint ventures to own and operate foundries and the licensing of our proprietary technology. We hold an equity investment in Grace Semiconductor Manufacturing Corporation, or GSMC, a Cayman Islands company. Grace is GSMC's wafer foundry subsidiary and is located in Shanghai, People's Republic of China.

*Packaging, Testing and Finishing.* In the assembly process, the individual dies are separated and assembled into packages. Following assembly, the packaged devices require testing and finishing to segregate conforming from nonconforming devices and to identify devices by performance levels. Currently, all devices are tested and inspected pursuant to our quality assurance program at our international subcontracted test facilities before shipment to customers. Certain facilities currently perform consolidated assembly, packaging, test and finishing operations all at the same location. During 2006, most subcontracted facilities performing the substantial majority of our operations were in Taiwan. The subcontractors with the largest amount of our activity are KYE, Lingsen, and Powertech Technology, Incorporated, or PTI. We hold equity investments in three subcontractors: Apacer Technology, Inc., or Apacer, KYE and PTI. For newly released products, the initial test and finishing activities are performed at our Sunnyvale facility.

### *Research and Development*

We believe that our future success will depend in part on the development of next generation technologies with reduced feature size. During 2004, 2005 and 2006, we spent \$46.4 million, \$48.7 million and \$53.0 million, respectively, on research and development. Our research efforts are focused on process development and product development. Our research strategy is to collaborate with our partners to advance our technologies. We work simultaneously with several partners on the

development of multiple generations of technologies. In addition, we allocate our resources and personnel into category-specific teams to focus on new product development. From time to time we invest in, jointly develop with, license or acquire technology from other companies in the course of developing products.

### ***Competition***

The semiconductor industry is intensely competitive and has been characterized by price erosion, rapid technological change and product obsolescence. We compete with major domestic and international semiconductor companies, many of whom have substantially greater financial, technical, marketing, distribution, manufacturing and other resources than us. Our low density memory products, sales of which presently account for substantially all of our revenues, compete against products offered by Macronix, ST Microelectronics, PMC, EON, and Winbond. Our medium-density memory products compete with products offered by Spansion, Macronix, Winbond, Samsung and ST Microelectronics. If we are successful in developing our high-density products, these products will compete principally with products offered by Spansion, Intel, Samsung, and ST Microelectronics, as well as any new companies who may enter the market. In addition, competition may come from alternative technologies such as ferroelectric random access memory device, or FRAM, technology.

The competition in the existing markets for some of our other product families, such as the FlashFlex51 microcontroller product family, is extremely intense. We compete principally with major companies such as Atmel, Microchip Technology, Freescale Semiconductor, Inc, Philips and Winbond in the microcontroller market. We may, in the future, also experience direct competition from our foundry partners. We have licensed to our foundry partners the rights to fabricate certain products based on our proprietary technology and circuit design, and to sell such products worldwide, subject to royalty payments back to us. Our smartcard products compete with Masked ROM and flash or EEPROM offerings primarily from Infineon, Renesas, Samsung and STMicroelectronics. For radio frequency IC products, the competition in the existing markets is also extremely intense. Our radio frequency IC products compete primarily with Microsemi, SiGe, Richwave, and Anadigics especially in the WLAN markets.

We compete principally on price, reliability, functionality and the ability to offer timely delivery to customers. While we believe that our low density memory products currently compete favorably on the basis of cost, reliability and functionality, it is important to note that some of our principal competitors have a significant advantage over us in terms of greater financial, technical and marketing resources. Our long-term ability to compete successfully in the evolving flash memory market will depend on factors both within and beyond our control, including access to advanced process technologies at competitive prices, successful and timely product development, wafer supply, product pricing, actions of our competitors and general economic conditions.

### ***Employees***

As of December 31, 2006, we employed 633 individuals on a full-time basis, 390 of whom reside in the United States. Of these 633 employees, 109 were employed in manufacturing support, 334 in engineering, 96 in sales and marketing and 94 in administration, finance and information technology. Our employees are not represented by a collective bargaining agreement, nor have we ever experienced any work stoppage related to strike activity. We believe that our relationship with our employees is good.

### ***Available Information***

We were incorporated in California in 1989. Additional information is available free of charge through our Internet website, [www.sst.com](http://www.sst.com). This information includes our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and, if applicable, amendments to those reports filed or furnished pursuant to Section 13(a) of the Exchange Act as soon as reasonably practicable after we electronically file such material with, or furnish it to, the SEC.

**Item 1A. Risk Factors**

**Risks Related to Our Business**

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

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

Our historical stock option granting practices and the restatement of our prior financial statements have exposed us to greater risks associated with litigation and regulatory proceedings. As described in Item 3. "Legal Proceedings," several derivative complaints have been filed against our directors and certain of our executive officers pertaining to allegations relating to stock option grants. These or future similar complaints, or any future litigation or regulatory action may not result in the same conclusions reached by the Chairman of the Audit Committee. The conduct and resolution of these matters or other litigation will be time consuming, expensive and may distract management from the conduct of our business.

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

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

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

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

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

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

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

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

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

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

## Edgar Filing: SILICON STORAGE TECHNOLOGY INC - Form 10-K

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

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

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

the availability, timely delivery and cost of wafers or other manufacturing and assembly services from our suppliers;

competitive pricing pressures and related changes in selling prices;

fluctuations in manufacturing yields and significant yield losses;

new product announcements and introductions of competing products by us or our competitors;

product obsolescence;

lower of cost or market, obsolescence or other inventory adjustments;

changes in demand for, or in the mix of, our products;

the gain or loss of significant customers;

market acceptance of products utilizing our SuperFlash® technology;

changes in the channels through which our products are distributed and the timeliness of receipt of distributor resale information;

exchange rate fluctuations;

general economic, political and environmental-related conditions, such as natural disasters;

changes in our allowance for doubtful accounts;

valuation allowances on deferred tax assets based on changes in estimated future taxable income;

difficulties in forecasting, planning and management of inventory levels;

unanticipated research and development expenses associated with new product introductions; and

the timing of significant orders and of license and royalty revenue.

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

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

Our operating expenses are relatively fixed, and we therefore have limited ability to reduce expenses quickly in response to any revenue shortfalls. Consequently, our operating results will be



harmful if our revenues do not meet our projections. We may experience revenue shortfalls for the following reasons:

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

significant declines in selling prices that occur because of competitive price pressure during an over-supply market environment;

sudden shortages of raw materials for fabrication, test or assembly capacity constraints that lead our suppliers to allocate available supplies or capacity to other customers which, in turn, harm our ability to meet our sales obligations; and

the reduction, rescheduling or cancellation of customer orders.

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

**We incurred significant inventory valuation and adverse purchase commitment adjustments in 2004, 2005 and 2006 and we may incur additional significant inventory valuation adjustments in the future.**

We typically plan our production and inventory levels based on internal forecasts of customer demand, which are highly unpredictable and can fluctuate materially. The value of our inventory is dependent on our estimate of future average selling prices, and, if our projected average selling prices are over estimated, we may be required to adjust our inventory value to reflect the lower of cost or market. As of December 31, 2006, we had \$73.9 million of net inventory on hand, a decrease of \$34.8 million, or 32.0%, from December 31, 2005. Total valuation adjustments to inventory and adverse purchase commitments were \$36.5 million in 2005 and \$15.2 million in 2006. Due to the large number of units in our inventory, even a small change in average selling prices could result in a significant adjustment and could harm our financial results. Some of our customers have requested that we ship them product that has a finished goods date of manufacture that is less than one year. As of December 31, 2006, our allowance for excess and obsolete inventories includes an allowance for our on hand finished goods inventory with a date of manufacture of greater than two years and for certain products with a date of manufacture of greater than one year. In the event that this becomes a common requirement, it may be necessary for us to provide for an additional allowance for our on hand finished goods inventory with a date of manufacture of greater than one year, which could result in a significant adjustment and could harm our financial results.

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

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

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

During 2004, 2005 and 2006, our international product and licensing revenues accounted for 92.7%, 95.1% and 94.7% of our net revenues, respectively. Our international business activities are subject to a number of risks, each of which could impose unexpected costs on us that would harm our operating results. These risks include:

difficulties in complying with regulatory requirements and standards;

tariffs and other trade barriers;

costs and risks of localizing products for foreign countries;

reliance on third parties to distribute our products;

extended accounts receivable payment cycles;

potentially adverse tax consequences;

limits on repatriation of earnings; and

burdens of complying with a wide variety of foreign laws.

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

We derived 86.0%, 87.6% and 87.7% of our net product revenues from Asia during 2004, 2005 and 2006, respectively. Additionally, substantially all of our wafer suppliers and packaging and testing subcontractors are located in Asia. Any kind of economic, political or environmental instability in this region of the world can have a severe negative impact on our operating results due to the large concentration of our production and sales activities in this region. If countries where we do business experience severe currency fluctuation and economic deflation, it can negatively impact our revenues and also negatively impact our ability to collect payments from customers. In this event, the lack of capital in the financial sectors of these countries may make it difficult for our customers to open letters of credit or other financial instruments that are guaranteed by foreign banks. Finally, the economic situation can exacerbate a decline in selling prices for our products as our competitors reduce product prices to generate needed cash.

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

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

We make investments in companies around the world to further our strategic objectives and support our key business initiatives. Such investments include investments in equity securities of public companies and investments in non-marketable equity securities of private companies, which range from early-stage companies that are often still defining their strategic direction to more mature companies whose products or technologies may directly support our products or initiatives. The success of these companies is dependent on product development, market acceptance, operational efficiency, and other key business success factors. The private companies in which we invest may fail because they may not be able to secure additional funding, obtain favorable investment terms for future financings, or take



advantage of liquidity events such as initial public offerings, mergers, and private sales. If any of these private companies fail, we could lose all or part of our investment in that company. If we determine that an other-than-temporary decline in the fair value exists for the equity securities of the public and private companies in which we invest, we write down the investment to its fair value and recognize the related write-down as an investment loss. Furthermore, when the strategic objectives of an investment have been achieved, or if the investment or business diverges from our strategic objectives, we may decide to dispose of the investment. Our investments in nonmarketable equity securities of private companies are not liquid, and we may not be able to dispose of these investments on favorable terms or at all. The occurrence of any of these events could negatively affect our results of operations.

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

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

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

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

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

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

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

We out-source our end customer service logistics in Asia to SPT, which supports our customers in Taiwan, China and other Southeast Asia countries. SPT provides forecasting, planning, warehousing, delivery, billing, collection and other logistic functions for us in these regions. SPT is a wholly owned subsidiary of Professional Computer Technology, or PCT, which is one of our stocking representatives in Taiwan. During 2004, 2005 and 2006, SPT serviced end customer shipments accounting for 52.9%, 58.5% and 59.1%, respectively, of our net product revenues recognized. As of December 31, 2005 and 2006, SPT accounted for 69.6%, and 68.9% respectively, of our net accounts receivable. For further description of our relationships with PCT and SPT, please refer to Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operation Related Party Transactions."

We do not have any long-term contracts with SPT, PCT or Silicon Professional Alliance Corporation, or SPAC, another subsidiary of PCT. SPT, PCT or SPAC may cease providing services to us at any time. If SPT, PCT or SPAC were to terminate their relationship with us we would experience

a delay in reestablishing warehousing, logistics and distribution functions, and it could impair our ability to collect accounts receivable from SPT and may harm our business.

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

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

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

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

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

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

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

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

The fabrication of our products requires wafers to be produced in a highly controlled and ultra-clean environment. Semiconductor companies that supply our wafers have, from time to time,

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

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

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

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

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

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

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

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

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

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

We compete with major domestic and international semiconductor companies, many of which have substantially greater financial, technical, marketing, distribution, and other resources than we do. Many of our competitors have their own facilities for the production of

semiconductor memory components

and have recently added significant capacity for such production. Our low density memory products, medium density memory products, and high density memory products, if we are successful in developing these products, face substantial competition. In addition, we may in the future experience direct competition from our foundry partners. We have licensed to our foundry partners the right to fabricate products based on our technology and circuit design, and to sell such products worldwide, subject to our receipt of royalty payments. Competition may also come from alternative technologies such as ferroelectric random access memory devices, or FRAM, magneto-resistive random access memory, or MRAM, or other developing technologies.

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

The markets for our products are characterized by:

rapidly changing technologies;

evolving and competing industry standards;

changing customer needs;

frequent new product introductions and enhancements;

increased integration with other functions; and

rapid product obsolescence.

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

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

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

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





require the addition of new management and engineering personnel and the development of additional expertise by existing management personnel. The failure to recruit and retain key design engineers or other technical and management personnel could harm our business.

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

We rely on a combination of patent, trade secrets, copyrights, mask work rights, nondisclosure agreements and other contractual provisions and technical measures to protect our intellectual property rights. Policing unauthorized use of our products, however, is difficult, especially in foreign countries. Litigation may continue to be necessary in the future to enforce our intellectual property rights, to protect our trade secrets, to determine the validity and scope of the proprietary rights of others, or to defend against claims of infringement or invalidity. Litigation could result in substantial costs and diversion of resources and could harm our business, operating results and financial condition regardless of the outcome of the litigation. As of December 31, 2006, we held 206 patents in the United States relating to certain aspects of our products and processes, with expiration dates ranging from 2010 to 2026 and have filed for several more. In addition, we hold several patents in Europe, Japan, Korea, Taiwan, and China. We cannot assure you that any pending patent application will be granted. Our operating results could be harmed by the failure to protect our intellectual property.

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

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

From time to time, we are also involved in other legal actions arising in the ordinary course of business. We have accrued certain costs associated with defending these matters. There can be no assurance that the shareholder class action complaints, the shareholder derivative complaints or other third party assertions will be resolved without costly litigation, in a manner that is not adverse to our financial position, results of operations or cash flows or without requiring payments in the future which may adversely impact gross margins. No estimate can be made of the possible loss or possible range of loss associated with the resolution of these contingencies. As a result, no losses have been accrued in our financial statements as of December 31, 2006.

During the course of these lawsuits there may be public announcements of the results of hearings, motions, and other interim proceedings or developments in the litigation. If securities analysts or investors perceive these results to be negative, it could harm the market price of our stock. We have incurred certain costs associated with defending these matters, and at any time, additional claims may be filed against us, which could increase the risk, expense and duration of the litigation. Further, because of the amount of discovery required in connection with this type of litigation, there is a risk that some of our confidential information could be compromised by disclosure. For more information with respect to our litigation, please also see Item 3. "Legal Proceedings."

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

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

We receive from time to time, letters or communications from other companies stating that such companies have patent rights that involve our products. Since the design of most of our products is based on SuperFlash technology, any legal finding that the use of our SuperFlash technology infringes the patent of another company would have a significantly negative effect on our entire product line and operating results. Furthermore, if such a finding were made, there can be no assurance that we 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, offering to sell or importing into the United States any products that infringe the protected technology. In addition, the management attention consumed by and legal cost associated with any litigation could harm our operating results. During the course of these lawsuits there may be public announcements of the results of hearings, motions, and other interim proceedings or developments in the litigation. If securities analysts or investors perceive these results to be negative, it could harm the market price of our stock.

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

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

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

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

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

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

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

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

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

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

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

Should we determine in future fiscal periods that we have additional material weaknesses in our internal controls over financial reporting, the reliability of our financial reports may be impacted, and

our results of operations or financial condition may be harmed and the price of our common stock may decline.

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

A change in accounting standards or practices or a change in existing taxation rules or practices can have a significant effect on our reported results and may even affect reporting of transactions completed before the change is effective. New accounting pronouncements and taxation rules and varying interpretations of accounting pronouncements and taxation practice have occurred and may occur in the future. Changes to existing rules or the questioning of current practices may adversely affect our reported financial results or the way we conduct our business. For example, we adopted SFAS No. 123(R) in the first quarter of 2006 which requires us to record charges to earnings for the stock options we grant and purchases of our common stock under our employee stock purchase plan.

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

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

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

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

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

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

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

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

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

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

### **Risks Related to Our Industry**

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

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

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

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

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

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

**Item 1B. Unresolved Staff Comments**

None.

**Item 2. Properties**

As of December 31, 2006, we occupied three major facilities totaling approximately 131,000 square feet in Sunnyvale, California which is where our executive offices, research and development, principal manufacturing engineering and testing facilities are located. Of the three major facilities occupied, we own one facility totaling approximately 20,000 square feet and we lease two facilities totaling approximately 111,000 square feet. The leases on the two facilities expire in 2010. We also have approximately 99,000 square feet of office space in various domestic and international sites with expiration ranging from 2008 to 2026. We believe these facilities and any others we may lease in the future are adequate to meet our needs for at least the next 12 months.

For information regarding long-lived assets by geography, see Note 17. "Segment Reporting" to our consolidated financial statements.

**Item 3. Legal Proceedings**

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

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

to continue to take all appropriate actions in response to this lawsuit. The impact related to the outcome of this matter is undeterminable at this time.

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

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

From time to time, we are also involved in other legal actions arising in the ordinary course of business. We have accrued certain costs associated with defending these matters. There can be no assurance that the shareholder class action complaints, the shareholder derivative complaints or other third party assertions will be resolved without costly litigation, in a manner that is not adverse to our financial position, results of operations or cash flows or without requiring payments in the future which may adversely impact net income. No estimate can be made of the possible loss or possible range of loss associated with the resolution of these contingencies. As a result, no losses associated with these or other litigation have been accrued in our financial statements as of December 31, 2006.

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

No matters were submitted during the fourth quarter of 2006 to a vote of security holders.



## PART II

## Item 5. Market for Registrant's Common Stock, Related Stockholder Matters and Issuer Purchases of Equity Securities

*Price Range of Common Stock*

The principal U.S. market for our common stock is the NASDAQ Global Market (formerly the NASDAQ National Market). The only class of our securities that is traded is our common stock. Our common stock has traded on the NASDAQ Global Market since November 21, 1995, under the symbol SSTI. The following table sets forth the quarterly high and low closing sales prices of the common stock for the period indicated as reported by the NASDAQ Global Market. These prices do not include retail mark-ups, markdowns, or commissions. The closing sales price of our common stock on December 29, 2006, the last trading day in 2006, was \$4.51.

<b>2005</b>		<b>High Close</b>	<b>Low Close</b>
First Quarter:	January 1 - March 31, 2005	\$ 5.72	\$ 3.47
Second Quarter:	April 1 - June 30, 2005	4.18	2.55
Third Quarter:	July 1 - September 30, 2005	5.67	4.12
Fourth Quarter:	October 1 - December 31, 2005	6.02	4.58
<b>2006</b>		<b>High Close</b>	<b>Low Close</b>
First Quarter:	January 1 - March 31, 2006	\$ 5.57	\$ 4.00
Second Quarter:	April 1 - June 30, 2006	5.00	3.49
Third Quarter:	July 1 - September 30, 2006	4.31	3.55
Fourth Quarter:	October 1 - December 31, 2006	4.86	4.04

*Comparison of Five Year Cumulative Total Return (1)*

The following graph compares the total cumulative stockholder return on our common stock with the total cumulative return of the NASDAQ Composite Index and the RDG Semiconductor Composite Index for the five year period from December 31, 2001 through December 31, 2006.

**COMPARISON OF 5 YEAR CUMULATIVE TOTAL RETURN\***  
**Among Silicon Storage Technology, Inc., The NASDAQ Composite Index**  
**And The RDG Semiconductor Composite Index**

\*  
\$100 invested on 12/31/01 in stock or index-including reinvestment of dividends. Fiscal year ending December 31.

---

(1)  
This stock performance chart shall not be deemed to be "soliciting material" or be deemed "filed" with the SEC, nor shall such information be incorporated by reference into any future filing under the Securities Act of 1933 or Securities Exchange Act of 1934, each as amended, except to the extent that we specifically incorporate it by reference into such filing.

*Approximate Number of Equity Security Holders*

As of December 31, 2006, there were approximately 653 record holders of our common stock.

*Dividends*

We have never paid a cash dividend on our common stock and we intend to continue to retain earnings, if any, to finance future growth. Accordingly, we do not anticipate paying cash dividends to holders of common stock in the foreseeable future.

*Equity Compensation Plan Information*

Information regarding our equity compensation plans is contained in Item 12. "Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters" under the caption "Securities Authorized for Issuance Under Equity Compensation Plans," and is

incorporated herein by reference.

**Item 6. Selected Consolidated Financial Data**

The following table includes selected consolidated financial data for each of the last five years and includes adjustments for the years ended December 31, 2004 and 2005 for changing to the equity method of accounting from the cost method for our investment in ACET as discussed in Note 8. to the consolidated financial statements.

The consolidated balance sheets as of December 31, 2002, 2003, 2004 and 2005, and the consolidated statements of operations for the years ended December 31, 2002, 2003, 2004 and 2005, have been restated to reflect the impact of the stock-based compensation adjustments and other adjustments that were previously considered immaterial. The information set forth below is not necessarily indicative of results of future operations, and should be read in conjunction with Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations" and the consolidated financial statements and related notes thereto included in Item 8. "Financial Statements and Supplementary Data" of this Annual Report on Form 10-K to fully understand factors that may affect the comparability of the information presented below. The information presented in the following tables has been adjusted to reflect the restatement of the financial results, which is more fully described in the Explanatory Note immediately preceding Item 1. "Business" and in Note 2. "Restatement of Consolidated Financial Statements" to our consolidated financial statements.

We have not amended our previously-filed Annual Reports on Form 10-K or Quarterly Reports on Form 10-Q for the periods affected by this restatement.

Edgar Filing: SILICON STORAGE TECHNOLOGY INC - Form 10-K

Year ended December 31,

	2002(4)		2003(4)		2004(1)(2)(4)			2005(1)(2)(4)		2006(3)	
	as previously reported	as restated	as previously reported	as restated	as previously reported	as adjusted and restated	as adjusted and restated	as previously reported	as adjusted	as adjusted and restated	
(in thousands, except per share data)											
<b>Consolidated Statements of Operations Data:</b>											
Net revenues	\$ 274,658	\$ 274,658	\$ 295,041	\$ 295,041	\$ 449,198	\$ 449,198	\$ 449,198	\$ 430,899	\$ 430,899	\$ 430,899	\$ 452,509
Cost of revenues	206,246	207,655	218,775	219,289	322,093	322,093	322,059	353,128	353,128	352,417	333,643
Gross profit	68,412	67,003	76,266	75,752	127,105	127,105	127,139	77,771	77,771	78,482	118,866
Total operating expenses	89,664	98,421	117,663	122,408	100,866	100,866	97,726	104,521	104,521	102,615	102,745
Income (loss) from operations	(21,252)	(31,418)	(41,397)	(46,656)	26,239	26,239	29,413	(26,750)	(26,750)	(24,133)	16,121
Net income (loss)	\$ (15,095)	\$ (21,524)	\$ (65,167)	\$ (84,849)	\$ 23,929	\$ 23,357	\$ 26,656	\$ (29,838)	\$ (29,265)	\$ (26,624)	\$ (20,777)
Net income (loss) per share basic	\$ (0.16)	\$ (0.23)	\$ (0.69)	\$ (0.90)	\$ 0.25	\$ 0.24	\$ 0.28	\$ (0.29)	\$ (0.29)	\$ (0.26)	\$ (0.20)
Net income (loss) per share diluted	\$ (0.16)	\$ (0.23)	\$ (0.69)	\$ (0.90)	\$ 0.24	\$ 0.24	\$ 0.27	\$ (0.29)	\$ (0.29)	\$ (0.26)	\$ (0.20)
<b>Consolidated Balance Sheet Data:</b>											
Total assets	\$ 440,606	\$ 455,152	\$ 396,361	\$ 396,621	\$ 502,331	\$ 501,759	\$ 501,440	\$ 477,837	\$ 477,837	\$ 478,212	\$ 465,978
Long-term obligations	\$ 1,873	\$ 1,873	\$ 1,423	\$ 1,423	\$ 1,307	\$ 1,307	\$ 1,307	\$ 2,627	\$ 2,627	\$ 2,627	\$ 2,030
Shareholders' equity	\$ 381,851	\$ 382,502	\$ 331,497	\$ 318,937	\$ 375,984	\$ 375,412	\$ 368,315	\$ 379,833	\$ 379,833	\$ 375,944	\$ 365,715

- (1) Results of operations include the effects of the acquisitions of Emosyn LLC and G-Plus, Inc. in 2004 and the acquisition of Actrans Systems Inc. in 2005.
- (2) Results of operations for 2004 and 2005 have been adjusted to account for the change to equity method accounting for our investment in ACET.
- (3) Results of operations for 2006 include the effect of SFAS No. 123(R), Stock-based Compensation as well as the impairment of our equity investments in Grace Semiconductor Manufacturing Corporation of \$40.6 million and Nanotech Inc. of \$3.5 million and the gain on the sale of our investment in PTI of \$12.2 million.
- (4) Results of operations include impact of stock-based compensation as discussed in Note 2 to the Consolidated Financial Statements.



## Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

### *Forward-looking Information*

Except for the historical information contained herein, the following discussion contains forward-looking statements that involve risks and uncertainties. All forward-looking statements included in this document are based on information available to us on the date hereof, and we assume no obligation to update any such forward-looking statements. Our actual results could differ materially from those discussed. Factors that could cause or contribute to such differences include, but are not limited to, those discussed in Item 1A. "Risk Factors," as well as those discussed elsewhere in this report.

### *Restatement of Consolidated Financial Statements, Audit Committee and Findings*

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

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

Based on the findings of the Chairman, we identified a number of occasions on which we used an incorrect measurement date for financial accounting and reporting purposes. These errors resulted primarily from our use from 1997 through mid-2002, of certain date selection methods discussed below which resulted in grantees receiving options with stated exercise prices lower than the market price of the underlying stock on the revised measurement dates. We ceased using such practices beginning in mid-2002. The Chairman found that, beginning in mid-2002, we improved our stock option grant processes with respect to new hire, merit and promotion grants and have generally granted and priced our stock options for new hires, merit and promotions in an objective and consistent manner since that time. However, from 1997 through 2005, we used incorrect measurement dates for financial accounting and reporting purposes for company-wide or retention stock option grants and in various other circumstances as discussed further below. The Chairman's review did not identify any additional stock-based compensation charges from measurement date issues subsequent to 2005.

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

For all periods through December 31, 2005, we have recorded aggregate non-cash stock-based compensation charges of \$38.8 million, associated payroll tax charges of \$4.3 million and a related income tax benefit of \$1.0 million. We have amortized a substantial portion of the APB No. 25 charges on a straight-line basis to expense during 1997 to 2005. If an option is forfeited prior to vesting, we reverse to income the charges amortized to expense in prior periods relating to unvested options and

reverse any remaining unamortized deferred stock-based compensation associated with the forfeited options to additional paid in capital. Accordingly, our net stock-based compensation charges amortized to our statement of income are lower than the aggregate stock-based compensation charges determined on the measurement date based on APB No. 25. As of December 31, 2005, the remaining APB No. 25 unamortized deferred stock-based compensation related to the errors identified during the review was approximately \$558,000.

The types of errors we identified were as follows:

*Improper Measurement Dates for New Hire, Merit and Promotion Stock Option Grants during 1997.* In connection with stock option grants that we made to newly-hired and existing employees for merit increases and promotion grants during the first three quarters of 1997, our practice was to grant stock options with an exercise price based upon the lowest closing price of our common stock in the month of hire, promotion or merit increase. The selection of the grant date of the related option grants would be made at the end of the month and was based on achieving the lowest exercise price for the affected employees. As a result of these practices, the measurement date for such options for accounting purposes was actually subsequent to the stated grant date, resulting in new measurement dates for the related options. The total amount of these errors was \$22,000.

*Improper Measurement Dates for New Hire, Merit and Promotion Stock Option Grants during 1997 to mid-2002.* In connection with certain stock option grants to newly-hired employees and merit and promotion grants to existing employees during the last quarter of 1997 through mid-2002, our practice was to delay the selection of the related grant dates until the end of a three-month period in the fiscal quarter during which the employees who received the grants began their employment or received their promotion or merit increase. As a result of this practice, the exercise price of the related option grants was not determined until subsequent to the stated grant date. We also determined that we generally set the grant date and exercise price of employee option grants for new hires, promotions and merit increases, by looking back to group awards according to grant dates that achieved the lowest possible exercise price for a group of employees. As a result of these practices, the measurement date for such options for accounting purposes was actually subsequent to the stated grant date, resulting in new measurement dates for the related options. The cumulative effect of these errors through December 31, 2005 was \$19.1 million.

*Improper Measurement Dates for Company-Wide Annual or Retention Stock Option Grants.* We determined that, in connection with certain annual or retention stock option grants that we made to employees from 1997 to 2003 and in 2005, the final number of shares that an individual employee was entitled to receive was not determined and/or the proper approval of the related stock option grant was not formally obtained until after the stated grant date. Therefore, the measurement date for such options for accounting purposes was actually subsequent to the stated grant date, resulting in new measurement dates for the related options. The cumulative effect of these errors through December 31, 2005 was \$12.5 million.

*Improper Measurement Dates for Director Stock Option Grants.* We determined that certain grants were made to members of the board of directors on discretionary dates rather than the non-discretionary prescribed dates under the 1995 Non-Employee Directors' Stock Option Plan. The 1995 Non-Employee Directors' Stock Option Plan prescribes the date of election or appointment and the date of the annual meeting of shareholders as the dates on which options are automatically granted. The members of the board of directors who received such grants have agreed to reprice upwards such grants and to pay us the difference between the original exercise price and the restated exercise price for options that have been exercised. Such amounts are not



## Edgar Filing: SILICON STORAGE TECHNOLOGY INC - Form 10-K

material to our consolidated financial statements. The cumulative effect of these errors through December 31, 2005 was \$118,000.

*Other Issues Identified.* We also identified other instances where stock option grants did not comply with applicable terms and conditions of our 1995 Equity Incentive Plan. For example, there were instances where option grants were made to groups of employees who joined SST pursuant to a business combination, and to a few other employees in certain instances, with stated exercise prices below the fair market value of our common stock on the actual measurement date of the related grants. We also determined that in certain cases, previously terminated employees who returned to SST were permitted to retain their original stock options. The cumulative effect of these errors through December 31, 2005 was \$7.1 million. In addition, in certain instances the exercise date of cash exercises of stock options appear to have been improperly reported which may have provided tax benefits to such optionees; however, such amounts are not material to our consolidated financial statements.

The Chairman carefully considered the involvement of current members of management and the board of directors in the stock option grant process and concluded that they were either unaware of the methods by which the exercise price for such options was determined and/or that such exercise price would have a financial statement impact. The Chairman did not reach any conclusions regarding former members of management. There is evidence, however, that a former non-management employee was aware of the methods by which the exercise price of such options was determined and that this employee may have been aware that the use of such methods was improper.

### *Use of Judgment*

In light of the significant judgment used by management in establishing revised measurement dates, alternative approaches to those used by us could have resulted in different stock-based compensation expenses than those recorded in the restated consolidated financial statements. We considered various alternative approaches and believe that the approaches used were the most appropriate under the circumstances.

### *Costs of Restatement and Legal Activities*

We have incurred substantial expenses for legal, accounting, tax and other professional services in connection with the independent review by the Chairman of the Audit Committee, our internal review, the preparation of the December 31, 2006 consolidated financial statements and the restated consolidated financial statements, and the derivative litigation. These expenses were approximately \$9.1 million from March 31, 2007 through November 30, 2007.

Additionally, we have reviewed the consequences of issuing in-the-money grants under Section 409A of the Internal Revenue Code and adverse tax consequences will result from our revision of accounting measurement dates for stock options that vest subsequent to December 31, 2004. These adverse tax consequences include a penalty tax payable by the option holder under Internal Revenue Code Section 409A and, as applicable, similar penalty taxes under state tax laws. We are considering offering active employees who are option holders the opportunity to amend or exchange their options to avoid the adverse tax consequences of Section 409A.

As a result of the errors we identified, we have restated our historical financial statements, from 1997 through 2005, to record \$42.0 million of charges related to stock-based compensation and associated payroll tax expense, net of related income tax effects. These errors resulted in after-tax benefits of \$3.7 million and \$1.8 million for 2004 and 2005, respectively. Additionally, the cumulative effect of the related after-tax charges for periods prior through the year ended December 31, 2003 was \$47.6 million. These additional stock-based compensation expense charges were non-cash and had no

Edgar Filing: SILICON STORAGE TECHNOLOGY INC - Form 10-K

impact on our reported revenue, cash, cash equivalents or marketable securities for each of the restated periods.

The financial statement impact of the restatement on previously reported stock-based compensation expense, including income tax impact by year, is as follows (in thousands):

Year	Adjustment to Stock-Based Compensation Expense	Adjustment to Payroll Tax Expense (Benefit)	Adjustment to Income Tax Expense (Benefit) Relating to Stock-Based Compensation and Payroll Tax Expense (Benefit)	Adjustment to Stock-Based Compensation Expense (Benefit), Net of Payroll and Income Taxes	Other Adjustments, Net of Income Taxes	Total Restatement Expense (Benefit)
1997	\$ 136	\$ 26	\$ (57)	\$ 105	\$	\$ 105
1998	209	3	(11)	201		201
1999	945	1,987	(40)	2,892		2,892
2000	10,964	7,563	(7,464)	11,063		11,063
2001	8,478	2,796	(4,027)	7,247		7,247
2002	8,297	1,520	(3,832)	5,985	444	6,429
2003	6,809	(1,074)	14,391	20,126	(444)	19,682
Cumulative through December 31, 2003	35,838	12,821	(1,040)	47,619		47,619
2004	2,302	(6,041)		(3,739)	1,012	(2,727)
2005	683	(2,515)		(1,832)	(1,382)	(3,214)
<b>Total</b>	<b>\$ 38,823</b>	<b>\$ 4,265</b>	<b>\$ (1,040)</b>	<b>\$ 42,048</b>	<b>\$ (370)</b>	<b>\$ 41,678</b>

For all periods through December 31, 2005, we have recorded aggregate non-cash stock-based compensation charges of \$38.8 million, associated payroll tax charges of \$4.3 million and a related income tax benefit of \$1.0 million. We also recorded previously immaterial audit differences of \$370,000 for all periods through December 31, 2005. Adjustments to stock-based compensation expense include \$6,000 of capitalized manufacturing variances for all periods through December 31, 2005. These adjustments had no impact on our reported revenue, cash, cash equivalents or marketable securities for each of the restated periods. We recorded an income tax benefit of \$0 for 2004 and 2005, respectively. The cumulative income tax benefit for periods prior to 2003 was \$1.0 million.

As part of this restatement, we also accrued liabilities and recorded charges to operating costs and expenses for certain payroll tax contingencies related to the incremental stock-based compensation expense in the amount of \$16.9 million for all annual periods from 1997 through 2005. We recorded such charges in the amount of \$1.6 million and \$300,000 for 2004 and 2005, respectively. Upon expiration of the related statute of limitations, we also recorded benefits from the reversal of previously-recorded payroll tax liabilities of \$7.7 million and \$2.8 million, in 2004 and 2005, respectively. As a result, the net benefit to our statements of income was \$6.0 million and \$2.5 million for 2004 and 2005, respectively. The cumulative payroll tax expense for periods prior to 2004 was \$12.8 million. For those stock option grants that we determined to have incorrect measurement dates for accounting purposes and that we had originally issued as incentive stock options, or ISOs, we recorded a liability for payroll tax contingencies in the event such grants would not be respected as ISOs under the Internal Revenue Code and the regulations thereunder. These liabilities were recorded with a charge to operating costs and expenses.

# Edgar Filing: SILICON STORAGE TECHNOLOGY INC - Form 10-K

## Restatement and Impact on Financial Statements

The income statement impact of the restatement is as follows (in thousands):

	Cumulative effect at December 31, 2003	2004	2005	Cumulative effect of Adjustments through December 31, 2005
Net income (loss) as previously reported		\$ 23,929	\$ (29,838)	
Total additional stock-based compensation expense (benefit)	\$ 35,838	2,302	683	\$ 38,823
Payroll tax expense (benefit)	12,821	(6,041)	(2,515)	4,265
Total pre-tax stock-option related adjustments	48,659	(3,739)	(1,832)	43,088
Income tax impact of stock option related adjustments	(1,040)			(1,040)
Total stock option related adjustments, net of income taxes	47,619	(3,739)	(1,832)	42,048
Adjustment due to change in accounting methodology for ACET		572	(573)	(1)
Other adjustments, net of tax		440	(809)	(369)
Total expense (benefit)	\$ 47,619	(2,727)	(3,214)	\$ 41,678
Net income (loss), as restated		\$ 26,656	\$ (26,624)	

We have not amended, and we do not intend to amend, any of our previously filed Annual Reports on Form 10-K, and we do not intend to amend any of our other previously filed Quarterly Reports on Form 10-Q for the periods affected by the restatement. We present restated quarterly financial information and the impact of the restatement for each of the quarters in 2006 and 2005 in Item 8. "Financial Statement and Supplementary Data Selected Quarterly Information (Unaudited)." Subsequent to the filing of this Annual Report on Form 10-K, we will be filing our Quarterly Reports on Form 10-Q for the periods ended March 31, 2007, June 30, 2007 and September 30, 2007 which contain restated financial statements for the corresponding periods in 2006.

### Overview

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

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

## Edgar Filing: SILICON STORAGE TECHNOLOGY INC - Form 10-K

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

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

Effective January 1, 2006, we re-evaluated how we internally review our business performance and, in turn, changed our operating segments. The new segments include Memory Products, Non-Memory Products and Technology Licensing. For other information related to our segments, see Note 17. "Segment Reporting" to our consolidated financial statements.

In our application categories, for 2006 as compared to 2005, revenue from wireless communications increased by 36.4% while revenue from our digital consumer applications declined by 7.9%, Internet computing applications declined by 0.71% and networking applications increased by 25.4%.

2006 was a year of engineering achievement as we assimilated the strategic acquisitions of the past three years and laid the foundation for new product announcements in 2007. We also achieved solid execution of our operating plan as well as operating profitability through all four quarters. Though the pricing environment in the low-density flash memory market continues to be challenging, we believe that the opportunity that fueled our growth in past years continues to be significant.

The demand for low-density NOR flash memory continues to grow at a steady pace. In 2006, we shipped more than 500 million units of memory products representing a compound annual growth rate of 30% in the past ten years. To date, we have shipped more than three billion units in total. This continued growth has been driven by the rapid proliferation of electronic products that have been designed around microprocessors and microcontrollers. Virtually all of these products incorporates some low density NOR flash memory for code storage. In some cases, the code size for each product is also increasing as consumers demand more features and functionality. Further, as our definition of low-density continues to expand into 16, 32 and 64 Mbit densities, the addressable market for our products grows steadily. We believe we are the leading supplier to the low density market and will strive to continue our leadership for many years to come.

### *Outlook*

Continuing price erosion, due to a competitive pricing environment, has been our biggest challenge in the last several years and has caused revenues in our memory business to remain approximately flat since 2005 despite strong increases in our unit shipments. To combat this, we have focused much of our engineering efforts on developing higher margin, non-commodity memory and non-memory products with higher average selling prices, or ASPs, in order to drive more growth in our revenue.

These products, which we began introducing in the fourth quarter of 2006 and which we continued to introduce over the course of 2007, we believe will have ASPs ranging from one to tens of dollars. In the non-commodity memory category, this will include serial flash in 3 volts at 32 and 64 Mbit densities, 1.8 volt products for densities up to 16Mbit and parallel flash products in 32 and 64Mbit densities. In the non-memory category, this will include NAND controllers and NAND-controller based

modules, high capacity subscriber identification modules, or SIMs, with 32bit processor cores, radio frequency modules and wireless audio modules.

In particular, we believe these higher ASP products will address key high volume applications surrounding the very high volume cell phone market and the rapidly growing HDTV market as well as significantly expand our market and allow us to participate in product areas that offer meaningful revenue growth opportunities.

### ***Concentrations***

We derived 86.0%, 87.6% and 87.7% of our net product revenues during 2004, 2005 and 2006, respectively, from product shipments to Asia. In addition, substantially all of our wafer suppliers and packaging and testing subcontractors are located in Asia.

Shipments to our top ten end customers, which exclude transactions through stocking representatives and distributors, accounted for 29.1%, 27.2% and 20.1% of our net product revenues in 2004, 2005 and 2006, respectively.

No single end customer, which we define as original equipment manufacturers, or OEMs, original design manufacturers, or ODMs, contract electronic manufacturers, or CEMs, or end users, represented 10.0% or more of our net product revenues during 2004, 2005 and 2006.

We ship products to, and have accounts receivable from, OEMs, ODMs, CEMs, stocking representatives, distributors, and our logistics center. Our stocking representatives, distributors and logistics center reship our products to our end customers, including OEMs, ODMs, CEMs and end users. Shipments, by us or our logistic center, to our top three stocking representatives for reshipment accounted for 34.0%, 40.3% and 48.5% of our product shipments in 2004, 2005 and 2006, respectively. In addition, the same three stocking representatives solicited sales, for which they received a commission, for 25.1%, 18.3% and 10.3% of our product shipments to end users in 2004, 2005 and 2006, respectively.

We out-source our end customer service logistics in Asia to Silicon Professional Technology Ltd., or SPT, which supports our customers in Taiwan, China and other Southeast Asia countries. SPT provides forecasting, planning, warehousing, delivery, billing, collection and other logistic functions for us in these regions. SPT is a wholly-owned subsidiary of one of our stocking representatives in Taiwan, Professional Computer Technology Limited, or PCT. Please see a description of our relationship with PCT under "Related Party Transactions." Products shipped to SPT are accounted for as our inventory held at our logistics center, and revenue is recognized when the products have been delivered and are considered as a sale to our end customers by SPT. For the years ended December 31, 2004, 2005 and 2006, SPT serviced end customer sales accounting for 52.9%, 58.5% and 59.1% of our net product revenues recognized. As of December 31, 2004, 2005 and 2006, SPT represented 55.1%, 69.6% and 68.9% of our net accounts receivable, respectively.

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 products. 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.

**Results of Operations****Net Revenues (in thousands)**

	Year Ended						
	December 31, 2004	December 31, 2005	December 31, 2006	Increase (Decrease) 2004 vs. 2005		Increase (Decrease) 2005 vs. 2006	
Memory revenue	\$ 374,553	\$ 331,691	\$ 350,156	\$ (42,862)	(11.4)%	\$ 18,465	5.6%
Non-Memory revenue	30,178	62,405	65,285	32,227	106.8%	2,880	4.6%
Product revenue	404,731	394,096	415,441	(10,635)	(2.6)%	21,345	5.4%
Technology licensing	44,467	36,803	37,068	(7,632)	(17.2)%	233	0.6%
<b>Total net revenues</b>	<b>\$ 449,198</b>	<b>\$ 430,899</b>	<b>\$ 452,509</b>	<b>\$ (18,299)</b>	<b>(4.1)%</b>	<b>\$ 21,610</b>	<b>5.0%</b>

Net revenues increased 5.0% for 2006 from 2005 primarily due to an 8.3% increase in unit shipments. Average selling prices of our products for 2006 decreased 3.1% from the same period in 2005 due to product mix and pricing pressures, particularly on serial flash and Smartcard IC products. Net revenues for 2005 decreased \$18.3 million, or 4.1%, from the prior year largely as a result of a 24.5% decrease in the average selling prices of our products due to industry oversupply and heavy competition in 2005. In addition to the decrease in the average selling prices of our products in 2005, we recognized lower up-front fees from our licensees due to the timing of new license agreements and milestone completions from existing agreements.

The following discussions are based on our reportable segments described in Note 17. of our consolidated financial statements.

*Memory Products*

Memory revenue increased 5.6% for 2006 from 2005 primarily due to a 3.7% increase in unit shipments. Increased demand for wireless communication products and networking applications led to the results. Memory revenue decreased in the year ended December 31, 2005 compared to December 31, 2004 primarily due to a 26.0% decrease in the average selling prices due to product mix and price erosion due to industry oversupply and heavy competition.

*Non-Memory Products*

Non-memory revenue increased 4.7% for 2006 from 2005 primarily due to a 30.8% increase in unit shipments. The increase in unit shipments was somewhat offset by a 24.5% decrease in average selling prices due to product mix and price erosion, primarily on SmartCard ICs. Non-memory revenue increased in 2005 from 2004 primarily due to a 118.0% increase in unit shipments. Average selling prices declined 3.4% during this same period.

*Technology Licensing Revenue*

Technology license revenue includes a combination of up-front fees and royalties. Technology licensing revenue remained relatively flat for 2006 from 2005 as a result of lower upfront fees as well as some upward fluctuation in royalties. Technology licensing revenue for 2005 compared to 2004 decreased year over year mainly due to the timing of achieving certain contractual milestone on new and existing licensees which in turn impacts the timing of the related revenue recognition. We anticipate revenues from technology licensing may fluctuate significantly in the future.

**Gross Profit (in thousands)**

	Year Ended			Increase (Decrease) 2004 vs. 2005		Increase (Decrease) 2005 vs. 2006	
	December 31, (as restated) 2004	December 31, (as restated) 2005	December 31, 2006				
Memory gross profit	\$ 77,110	\$ 26,277	\$ 64,156	\$ (50,833)	(65.9)%	\$ 37,879	144.2%
Memory gross margin	20.6%	7.9%	18.3%				
Non-Memory gross profit	5,562	15,402	17,642	9,840	176.9%	2,240	14.5%
Non-Memory gross margin	18.4%	24.7%	27.0%				
Product gross profit	82,672	41,647	81,798	(41,025)	(49.6)%	40,151	96.4%
Product gross margin	20.4%	10.6%	19.7%				
Technology licensing gross profit	44,467	36,803	37,068	(7,664)	(17.2)%	265	0.7%
Technology licensing gross margin	100.0%	100.0%	100.0%				
<b>Total gross profit</b>	<b>\$ 127,139</b>	<b>\$ 78,482</b>	<b>\$ 118,866</b>	<b>\$ (48,657)</b>	<b>(38.3)%</b>	<b>\$ 40,384</b>	<b>51.5%</b>
Total gross margin	28.3%	18.2%	26.3%				

Total gross profit increased \$40.4 million for 2006 compared to 2005 as we shipped a greater number of higher margin products, including embedded controllers and radio frequency ICs. This in turn benefited our total gross margin which was also favorably impacted by our continuing transition to the lower cost 0.18 and 0.25 micron die geometries. Gross profit also improved due to a \$21.3 million decline in our inventory provision as compared to 2005.

Our blended average selling prices, which take into account both product mix and selling prices decreased by 3.1% year over year, mainly due to the competitive pricing environment of low-density memory products. For 2005 compared to 2004, gross profit and gross margin decreased substantially. Industry oversupply and heavy competition in the first half of 2005 were the major contributors to the resulting in a 24.5% decrease in the average selling price of our products. In addition, we recognized lower up-front fees from our licensees due to the timing of new license agreements and milestone achievements from existing agreements.

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

*Product Gross Profit**Memory products*

Gross profit for memory products increased \$37.9 million for 2006 compared to 2005 largely due to a 3.7% increase in the number of units shipped, the continued transition to smaller geometries and lower write downs of inventory in 2006 as compared to 2005. For 2005 compared to 2004, we saw a \$50.8 million decline in gross profit due to market softness and pricing pressures, which contributed to a 26.0% decline in ASP for our memory products during this period.

*Non-memory products*

Gross profit for non-memory products increased \$2.3 million in 2006 compared to 2005 as total unit shipments increased 30.8%, led by our radio frequency IC products. This was partially offset by a 24.5% decline in average selling prices which was largely a result of changes in product mix. For 2005 compared to 2004, gross profit rose \$9.8 million as unit shipments more than doubled from the prior year. We expect some revenue fluctuation in non-memory business as we expect to grow and diversify our revenue and customer base.

**Operating Expenses (in thousands)***Research and development*

	Year Ended						
	December 31,	December 31,	December 31,	Increase 2004 vs. 2005	Increase 2005 vs. 2006		
	(as restated) 2004	(as restated) 2005	2006				
Research and development	\$ 46,397	\$ 48,746	\$ 52,969	\$ 2,349	5.1%	\$ 4,223	8.7%
Percent of revenue	10.3%	11.3%	11.7%				

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

For 2006 compared to 2005, research and development spending increased due to stock-based compensation expense of \$3.8 million as a result of the implementation of SFAS No. 123(R). Accruals in profit sharing of \$540,000 from increased profitability in 2006 also contributed to the increase. Research and development expenses increased 5.1% from 2004 to 2005 mainly due to a \$4.0 million increase in salaries and wages related to an increase in headcount from acquisitions, partially offset by \$1.8 million from the decrease of profit sharing in 2005. We expect that research and development expenses will fluctuate based on the timing of engineering projects for new product introductions and the development of new technologies to support future growth.

*Sales and marketing*

	Year Ended						
	December 31,	December 31,	December 31,	Increase (Decrease) 2004 vs. 2005	Increase (Decrease) 2005 vs. 2006		
	(as restated) 2004	(as restated) 2005	2006				
Sales and marketing	\$ 27,536	\$ 28,544	\$ 28,464	\$ 1,008	3.7%	\$ (80)	(0.3)%
Percent of revenue	6.1%	6.6%	6.3%				

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

Sales and marketing expense decreased in 2006 compared to 2005 due to lower commission related expenses of \$411,000 as well as lower patent expense of \$648,000. These expenses were offset by stock-based compensation expense of \$1.2 million. For 2005 compared to 2004, increased salaries and wages of \$1.8 million were mostly offset by decreases in commission expense of \$1.7 million. We expect that future sales and marketing expenses may increase in absolute dollars. In addition, fluctuations in revenues will cause fluctuations in sales and marketing expenses due to our commission expenses.

*General and administrative*

	Year Ended						
	December 31,	December 31,	December 31,	Increase (Decrease) 2004 vs. 2005	Increase (Decrease) 2005 vs. 2006		
	(as restated) 2004	(as restated) 2005	2006				
General and administrative	\$ 16,418	\$ 22,380	\$ 21,312	\$ 5,962	36.3%	\$ (1,068)	(4.8)%
Percent of revenue	3.7%	5.2%	4.7%				



## Edgar Filing: SILICON STORAGE TECHNOLOGY INC - Form 10-K

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

For 2006 compared to 2005, lower general and administrative expenses were due to decreased professional service fees of \$1.4 million, primarily due to work associated with a tax refund project, and outside Sarbanes-Oxley-related professional services of \$1.7 million. This was partially offset by stock-based compensation expenses of \$2.4 million arising from the implementation of SFAS No. 123(R) in 2006. The increase from 2004 to 2005 was largely due to increased accounting expenses and outside consulting fees of \$3.2 million associated with Sarbanes-Oxley compliance work and a one-time tax consulting fees from a tax refund project. General and administrative fees also reflect increased salaries and benefits of \$1.6 million related to increased headcount and increased amortization of acquired intangible assets of \$1.8 million. This was partially offset by decreased bad debt expense of \$1.2 million from lower provisions due to favorable historical activity. In addition to the increased expense related to SFAS No. 123(R), we anticipate that general and administrative expenses may increase in absolute dollars as we scale our facilities, infrastructure and headcount to support our overall expected growth.

### *Other operating expenses*

	Year Ended				
	December 31, 2004	December 31, 2005	December 31, 2006	2004 vs. 2005	2005 vs. 2006
Other operating expenses	\$ 7,375	\$ 2,945	\$	\$ (4,430)	(60.1)%
Percent of revenue	1.6%	0.7%	0.0%		(100.0)%

During the second quarter of 2005, we recorded other operating expense of \$2.9 million related to in-process research and development expense recognized in conjunction with the acquisitions of Actrans Systems Inc., the acquisition of the remaining minority interest in Emosyn and the settlement of our patent litigation case with Atmel. In 2004, these expenses were comprised of \$5.9 million related to the write off of in-process research and development expense relating to the acquisition of Emosyn and G-Plus and a \$1.5 million period charge related to an operating lease for an abandoned building. We incurred no other operating expenses during 2006.

### *Interest, Dividend and Other income and expense, net*

	Year Ended				
	December 31, (as adjusted) 2004	December 31, (as adjusted) 2005	December 31, 2006	Increase 2004 vs. 2005	Increase 2005 vs. 2006
Other income (expense), net	\$ 2,232	\$ 2,270	\$ 5,757	\$ 38	1.7%
Percent of revenue	0.5%	0.5%	1.3%	\$ 3,487	153.6%

Interest, dividend and other income and expense for the periods presented included mainly interest and dividend income on our cash and investments. For 2006 in comparison to 2005, other income rose due to greater levels of invested cash, and rising interest rates. Interest and other income increased from 2004 to 2005 primarily due to increased realized gains from the sale of some of our investments. We expect other income and expense will fluctuate as a result of changes in cash balances and the timing of dividends on our investments.

*Interest expense*

	Year Ended									
	December 31,	December 31,	December 31,							
	(as restated) 2004	(as restated) 2005	2006	Increase 2004 vs. 2005	Increase 2005 vs. 2006					
Interest expense	\$	\$	241	\$	345	\$	241	\$	104	43.2%
Percent of revenue		0.0%	0.1%	0.1%						

Interest expense remained relatively low as we do not have significant outstanding debt. On August 11, 2006, we entered into a 1-year loan and security agreement with Cathay Bank, a U.S. bank, for a \$40.0 million revolving line of credit, all of which was available to us as of December 31, 2006. As of December 31, 2006, a standby letter of credit in the amount of \$8.0 million was issued by to Bank of America as guarantee for a line of credit from them. As of December 31, 2006, SST China Limited, a wholly-owned owned subsidiary, has drawn RMB \$24 million, or approximately \$3.0 million U.S. dollars, at the interest rate of 5.02% under the Bank of America line of credit.

*Equity investments*

In the first quarter of 2006, we determined that our investment in Nanotech, Inc. had become impaired as Nanotech defaulted on its loan payments to certain of its business partners and began preparations to liquidate itself. As a result, we wrote our \$3.3 million investment down to zero as well as an outstanding loan of \$225,000. We believe the chances of recovering this investment are remote. During the fourth quarter of 2006, we reviewed the carrying value of our equity investment in Grace Semiconductor Manufacturing Corporation, or GSMC, for impairment. During this review, we became aware of certain pending equity transactions at a price per share below our carrying value. We considered this impairment to be other than temporary and, accordingly, recorded an impairment charge related to GSMC of approximately \$40.6 million to write down our investment to its estimated fair value.

During 2005 and 2004 we recorded impairment charges on our equity investments of \$605,000 and \$509,000, respectively. During the fourth quarter of 2005, we wrote down one of our investments, Advanced Chip Engineering Technology, or ACET, since ACET issued a secondary round of equity funding at a lower per share price than our carrying value. Consequently, we recorded an impairment charge of \$605,000 on our existing investment.

During the first quarter of 2006, we realized a pre-tax gain of \$12.2 million from the sale of 4.0 million shares of our investment in PTI. As of December 31, 2006, we owned 6.3 million shares of PTI.

*Pro Rata Share of Loss from Equity Investments*

In September 2006, we invested an additional \$15.9 million in ACET, which increased our ownership share from 9.4% to 46.9% and required us to change from the cost method of accounting to the equity method of accounting for this investment. Under the equity method of accounting, we are required to record our 46.9% interest in ACET's reported net income or loss each reporting period. In addition, we are required to restate prior period financial results to reflect the equity method of accounting from the date of the initial investment. The year ended December 31, 2006 and 2005 results include a charge of \$3.0 million and \$1.5 million, respectively, representing our share of ACET's reported net loss. In the third quarter ended September 30, 2007, we made additional cash investment of \$10.3 million in ACET's common stock, along with other investing enterprises. This brought our total investment down to 38.5% of the outstanding equity of ACET at September 30, 2007. We expect

to continue to record a share of pro rata share of losses for the foreseeable future. For further information, please refer to Note 8. to our consolidated financial statements.

	Year Ended				
	December 31,	December 31,	December 31,		
	(as adjusted) 2004	(as adjusted) 2005	2006	Increase 2004 vs. 2005	Increase 2005 vs. 2006
Pro rata share of loss from equity investments	\$ 665	\$ 1,543	\$ 3,199	\$ 878 132.0%	\$ 1,656 107.3%
<b>Provision for (Benefit from) Income Taxes</b>					

We maintained a full valuation allowance on our net deferred tax assets as of December 31, 2006. The valuation allowance was determined in accordance with the provisions of Statement of Financial Accounting Standards No. 109, or SFAS No. 109, *Accounting for Income Taxes*, which requires an assessment of both positive and negative evidence when determining whether it is more likely than not that deferred tax assets are recoverable; such assessment is required on a jurisdiction by jurisdiction basis. Expected future U.S. losses represented sufficient negative evidence under SFAS No. 109 and accordingly, a full valuation allowance was recorded against U.S. deferred tax assets. We intend to maintain a full valuation allowance on the U.S. deferred tax assets until sufficient positive evidence exists to support reversal of the valuation allowance.

Our tax provision for 2006 was \$7.2 million on a pre-tax loss of \$10.4 million consisting primarily of U.S. income taxes and foreign withholding taxes.

The provision for income taxes decreased to \$2.4 million in 2005 from \$3.9 million in 2004 primarily as a result of decrease in withholding taxes and the decrease in U.S. federal income tax. The 2005 effective rate was 10.8% and differs from the federal statutory benefit rate of (35%) primarily due to withholding taxes.

The provision for income taxes presented for 2005 and 2004 was not affected by the restatement for stock compensation charges.

## Segments

A key objective of ours is to diversify our product offerings away from a pure play in flash memory to become a multi-product line semiconductor company and a leading licensor of embedded flash technology. As a consequence, the operating results that our chief operating decision maker reviews to make decisions about resource allocations and to assess performance have changed. Effective January 1, 2006, we have re-evaluated our operating segments to bring them in line with these changes and how management reviews and evaluates the operating performance of the company and accordingly, the new segments include Memory Products, Non-Memory Products and Technology Licensing.

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

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

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

## Edgar Filing: SILICON STORAGE TECHNOLOGY INC - Form 10-K

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

Prior period segment information has been reclassified to conform to the current period's presentation.

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

	Year Ended December 31, 2004		Year Ended December 31, 2005		Year Ended December 31, 2006	
	Revenues	(as restated) Gross Profit	Revenues	(as restated) Gross Profit	Revenues	Gross Profit
Memory	\$ 374,553	\$ 77,110	\$ 331,719	\$ 26,277	\$ 350,156	\$ 64,156
Non-Memory	30,178	5,562	62,377	15,370	65,285	17,642
Technology Licensing	44,467	44,467	36,835	36,835	37,068	37,068
	<u>\$ 449,198</u>	<u>\$ 127,139</u>	<u>\$ 430,899</u>	<u>\$ 78,482</u>	<u>\$ 452,509</u>	<u>\$ 118,866</u>

### Related Party Transactions

The following table is a summary of our related party revenues and purchases (in thousands):

	Revenues		
	For the years ended December 31,		
	2004	2005	2006
Silicon Technology Co., Ltd	\$ 7,943	\$ 3,711	\$ 1,279
Apacer Technology, Inc. & related entities	2,359	2,180	3,087
Silicon Professional Technology Ltd	214,195	230,706	245,332
Grace Semiconductor Manufacturing Corp	156	1,577	1,480
	<u>\$ 224,653</u>	<u>\$ 238,174</u>	<u>\$ 251,178</u>
	Purchases		
	For the years ended December 31,		
	2004	2005	2006
Apacer Technology, Inc. & related entities	\$ 707	\$	\$
Grace Semiconductor Manufacturing Corp	59,278	45,373	69,153
King Yuan Electronics Company, Limited	38,248	34,882	30,550
Powertech Technology, Incorporated	14,718	15,111	16,159
	<u>\$ 112,951</u>	<u>\$ 95,366</u>	<u>\$ 115,862</u>

## Edgar Filing: SILICON STORAGE TECHNOLOGY INC - Form 10-K

The following table is a summary of our related party accounts receivable and accounts payable and accruals (in thousands):

	<u>Trade Accounts Receivable</u>		<u>Accounts Payable and Accruals</u>	
	<u>December 31, 2005</u>	<u>2006</u>	<u>December 31, 2005</u>	<u>2006</u>
Silicon Technology Co., Ltd	\$ 370	\$ 136	\$	\$
Advanced Chip Engineering Technology				84
Apacer Technology, Inc. & related entities	237	570		
Professional Computer Technology Limited			123	59
Silicon Professional Technology Ltd	53,785	44,750	846	686
Grace Semiconductor Manufacturing Corp	1,466	105	4,949	17,955
King Yuan Electronics Company, Limited			10,004	10,421
Powertech Technology, Incorporated			5,945	7,305
	<u>\$ 55,858</u>	<u>\$ 45,561</u>	<u>\$ 21,867</u>	<u>\$ 36,510</u>

In 1996, we acquired a 14% interest in Silicon Technology Co., Ltd., or Silicon Technology, a privately held Japanese company, for \$939,000 in cash. Bing Yeh, our President, CEO and Chairman of our Board of Directors, is also a member of Silicon Technology's board of directors. We acquired the interest in Silicon Technology in order to provide a presence for our products in Japan. We now have our own office in Japan, although Silicon Technology continues to sell our products. At December 31, 2006, our investment, which is carried at cost, represented 8.7% of the outstanding equity of Silicon Technology. Our sales to Silicon Technology were made at prevailing market prices and the payment terms are consistent with the payment terms extended to our other customers. We are not obligated to provide Silicon Technology with any additional financing.

In 2000, we acquired a 10% interest in Apacer Technology Inc, or Apacer, for \$9.9 million in cash. Apacer, a privately held Taiwanese company and a related entity of Acer, is a memory module manufacturer and customer. Bing Yeh, our President, CEO and Chairman of our Board of Directors, is also a member of Apacer's board of directors. In 2001, we invested an additional \$2.1 million in Apacer. In August 2002, we made an additional investment of \$181,000. The investment was written down to \$4.4 million during 2002. At December 31, 2006, our investment, which is carried at cost, represented 9.5% of the outstanding equity of Apacer. Our sales to the related Acer entities were made at prevailing market prices and the payment terms are consistent with the payment terms extended to our other customers. We do not have a long-term contract with Apacer to supply us with products. If Apacer were to terminate its relationship with us, we believe that we would be able to procure the necessary products from other production subcontractors. We are not obligated to provide Apacer with any additional financing.

In 2000, we acquired a 15% interest in Professional Computer Technology Limited, or PCT, a Taiwanese company, for \$1.5 million in cash. Bing Yeh, our President, CEO and Chairman of our Board of Directors, is also a member of PCT's board of directors. PCT is one of our stocking representatives. In May 2002, we made an additional investment of \$179,000 in PCT. During 2003, PCT completed an initial public offering on the Taiwan Stock Exchange and we sold a portion of our holdings. Under Taiwan security regulations, a certain number of shares must be held in a central custody and are restricted from sale for a period of time. The shares available for sale within one year are carried at the quoted market price and included in long-term available-for-sale investments in the balance sheet as of December 31, 2006. Shares required to be held in custody for greater than a one year period are carried at cost and included in equity investments. In February 2004, we purchased \$1.7 million of PCT's European convertible bonds. As of December 31, 2006, the value of the stock

and convertible bond investment recorded as long-term available-for-sale is valued at \$7.3 million and the restricted portion of the investment carried at cost is recorded at \$769,000. At December 31, 2006 our investment represented 11.2% of the outstanding equity and 13.2% of the European convertible bonds of PCT.

PCT and its subsidiary, Silicon Professional Alliance Corporation, or SPAC, earn commissions for point-of-sales transactions to its customers. Commissions to PCT and SPAC are paid at the same rate as all of our other stocking representatives in Asia. In 2004, 2005 and 2006 we paid sales commissions of \$579,000, \$315,000 and \$364,000, respectively, to PCT and SPAC. Shipments, by us or our logistics center, to PCT and SPAC for reshipment accounted for 31.3%, 38.9% and 42.6% of our product shipments in 2004, 2005 and 2006. In addition, PCT and SPAC solicited sales, for 3.3%, 2.0% and 2.0% of our shipments to end users in 2004, 2005 and 2006, respectively, for which they also earned a commission.

PCT has established a separate company and wholly-owned subsidiary, Silicon Professional Technology, Ltd., or SPT, to provide forecasting, planning, warehousing, delivery, billing, collection and other logistic functions for us in Taiwan. SPT now services substantially all of our end customers based in Taiwan, China and other Southeast Asia countries. Products shipped to SPT are accounted for as our inventory held at our logistics center, and revenue is recognized when the products have been delivered and are considered as a sale to our end customers by SPT. We pay SPT a fee based on a percentage of revenue for each product sold through SPT to our end customers. For the year ended December 31, 2006, we incurred \$3.7 million of fees related to SPT. The fee paid to SPT covers the cost of warehousing and insuring inventory and accounts receivable, personnel costs required to maintain logistics and information technology functions and the costs to perform billing and collection of accounts receivable. SPT receives extended payment terms and is obligated to pay us whether or not they have collected the accounts receivable.

We do not have any long-term contracts with SPT, PCT or SPAC, and SPT, PCT or SPAC may cease providing services to us at any time. If SPT, PCT or SPAC were to terminate their relationship with us we would experience a delay in reestablishing warehousing, logistics and distribution functions which would harm our business. We are not obligated to provide SPT, PCT or SPAC with any additional financing.

In 2000, we acquired a 1% interest in King Yuan Electronics Company, Limited, or KYE, a Taiwanese company, which is a production subcontractor, for \$4.6 million in cash. The investment was made in KYE in order to strengthen our relationship with KYE. During 2001, KYE completed an initial public offering on the Taiwan Stock Exchange. Accordingly, the investment has been included in long-term available-for-sale investments in the balance sheet as of December 31, 2006. The investment was written down to \$1.3 million during 2001 and is valued at \$3.5 million as of December 31, 2006 based on the quoted market price. At December 31, 2006, our investment represented 0.4% of the outstanding equity of KYE. Our purchases from KYE are made pursuant to purchase orders at prevailing market prices. We do not have a long-term contract with KYE to supply us with services. If KYE were to terminate its relationship with us, we believe that we would be able to procure the necessary services from other production subcontractors. We are not obligated to provide KYE with any additional financing.

In 2000, we acquired a 3% interest in Powertech Technology, Incorporated, or PTI, a Taiwanese company, which is a production subcontractor, for \$2.5 million in cash. Bing Yeh, our President, CEO and Chairman of our Board of Directors, is also a member of PTI's board of directors. The investment was made in PTI in order to strengthen our relationship with PTI. Under Taiwan security regulations, a certain number of shares must be held in a central custody and are restricted from sale for a period of time. The shares available for sale within one year are carried at the quoted market price and included in long-term available-for-sale investments in the balance sheet as of December 31, 2005 and 2006.

Shares required to be held in custody for greater than a one year period are carried at cost and included in equity investments. In August 2004, we invested \$723,000 cash in PTI shares available for sale. During the first quarter of 2006, we sold four million common shares of PTI for a net gain of \$12.2 million. Please see Note 17. to our consolidated financial statements. As of December 31, 2006, the value of the remaining investment is recorded as long-term available-for-sale is valued at \$26.3 million with no portion of the investment restricted and represents 1.3% of the outstanding equity of PTI. At December 31, 2005, our investment represented 1.3% of the outstanding equity of PTI. Our purchases from and sales to PTI are made at prevailing market prices. We do not have a long-term contract with PTI to supply us with services. If PTI were to terminate its relationship with us, we believe that we would be able to procure the necessary services from other production subcontractors. We are not obligated to provide PTI with any additional financing.

We invested \$83.2 million in GSMC, a Cayman Islands company. Bing Yeh, our President, CEO and Chairman of our Board of Directors, is also a member of GSMC's board of directors. GSMC has a wholly owned subsidiary, Shanghai Grace Semiconductor Manufacturing Corporation, or Grace, which is a wafer foundry company with operations in Shanghai, China. Grace began to manufacture our products in late 2003. We do not have a long-term contract with Grace to supply us with products. This investment is carried at cost. During the fourth quarter of 2006, we recorded an impairment charge of \$40.6 million on our existing investment. The impairment was considered to be "other-than-temporary" in nature, thus the investment value was permanently written down to its the fair value. At December 31, 2006, we owned 9.8% of the outstanding stock of GSMC.

In 2002, we acquired a 6% interest in Insyde Software Corporation, or Insyde, a Taiwanese company, for \$964,000 in cash. Bing Yeh, our President, CEO and Chairman of our Board of Directors, is also a member of Insyde's board of directors. During 2003, Insyde completed an initial public offering on the Taiwan Stock Exchange. Under Taiwan security regulations, a certain number of shares must be held in a central custody and are restricted from sale for a period of time. The shares available for sale within one year are carried at the quoted market price and included in long-term available-for-sale investments in the balance sheet as of December 31, 2005 and 2006. Shares required to be held in custody for greater than a one year period are carried at cost and included in equity investments. In January 2004, we invested an additional \$133,000 cash in Insyde's convertible bonds. The stock investment was written down \$509,000 during 2004. At December 31, 2006, our investment represented 6.1% of the outstanding equity and 6.3% of the convertible bonds of Insyde.

In June 2004, we acquired a 9% interest in ACET, a privately held Taiwanese company for \$4.0 million cash. ACET, a related entity of KYE, is a production subcontractor. Chen Tsai, our Senior Vice President of Worldwide Backend Operations, is also a member of ACET's board of directors. During 2005, we recorded a \$605,000 impairment charge related to our investment in ACET. ACET raised an additional round of equity financing at a lower per share cost than our current basis. Consequently, we determined that our investment was overvalued. Refer to Note 13 of the Consolidated Financial Statements. In September 2006, we invested an additional \$15.9 million in ACET that increased our ownership share of ACET's outstanding capital stock from 9.4% to 46.9% and required us to change from the cost method of accounting to the equity method of accounting for this investment. Under the equity method of accounting, we are required to record our 46.9% interest in ACET's reported net income or loss each reporting period as well as restate the prior period financial results to reflect the equity method of accounting from the date of the initial investment. The December 31, 2006, 2005 and 2004 year-to-date results include charges recorded in "pro rata share of loss from equity investments" on our condensed consolidated statement of operations. Under this accounting treatment, we recorded charges of \$665,000 for the year ended December 31, 2004, \$1.5 million for the year ended December 31, 2005 and \$3.0 million for the year ended December 31, 2006 representing our share of the losses for ACET. In the third quarter ended September 30, 2007, we made an additional cash investment, among other investing enterprises, of \$10.3 million in ACET's common stock. Our total investment represents 38.5% of the outstanding equity of ACET at September 30, 2007.

## Edgar Filing: SILICON STORAGE TECHNOLOGY INC - Form 10-K

In November 2004, we acquired a 30% interest in Nanotech Corporation, or Nanotech, a privately held Cayman Island company, for \$3.8 million cash. Nanotech, a development stage company, has a wholly owned subsidiary which is in the process of establishing foundry operations in China. Bing Yeh, our President, CEO and Chairman of our Board of Directors, is also a member of Nanotech's board of directors. Tsuyoshi Taira, a member of our Board of Directors, also invested in this round of financing. During the first quarter of 2006, we determined that our investment in Nanotech, Inc. had become impaired as Nanotech defaulted on its loan payments to certain of its business partners and began preparations to liquidate itself. As a result, we wrote our investment down to zero as well as an outstanding loan for \$225,000. We believe the chances of recovering this investment are remote and cannot be reasonably estimated.

In May 2006, we acquired a 2% interest in EoNex Technologies, Inc., or EoNex, a privately held Korean company, for \$3.0 million in cash. EoNex designs and manufactures wireless modem ICs and related software for various consumer devices. At December 31, 2006, our investment in EoNex remained at \$3.0 million.

### Critical Accounting Estimates

Our critical accounting estimates are as follows:

Revenue recognition;

Allowance for sales returns;

Allowance for doubtful accounts;

Allowance for excess and obsolete inventory and lower of cost or market;

Warranty accrual;

Litigation costs;

Valuation of equity investments;

Provision for adverse purchase commitments; and

Stock-based compensation

Accounting for income taxes

*Revenue recognition.* Sales to direct customers and foreign stocking representatives are recognized net of an allowance for estimated returns. When product is shipped to direct customers or stocking representatives, or by our distributors or SPT to end users, prior to recognizing revenue, we also require that evidence of the arrangement exists, the price is fixed or determinable and collection is reasonably assured. Legal title generally passes to our customers at the time our products are shipped. Payment terms typically range from 30 to 65 days. Sales to distributors are made primarily under arrangements allowing price protection and the right of stock rotation on merchandise unsold. Because of the uncertainty associated with pricing concessions and future returns, we defer recognition of such revenues, related costs of revenues and related gross profit until the merchandise is sold by the distributor. Products shipped to SPT are accounted for as our inventory held at our logistics center, and revenue is recognized when the products have been delivered and are considered as a sale to our end customers by SPT.

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 that we have historically enhanced and developed refinements to the technology, approximately two to 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 upgrade period is needed. Revenue from license or other technology arrangements where we are not continuing to enhance and refine 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.

Royalties received during the upgrade period under these arrangements are recognized as revenue based on the ratio of the elapsed portion of the upgrade period to the estimated upgrade period. The remaining portions of the royalties are recognized ratably over the remaining portion of the upgrade period. Royalties received after the upgrade period has elapsed are recognized when reported to us which generally occurs one quarters in arrears and concurrently with the receipt of payment.

If we make different judgments or utilize different estimates in relation to the estimated period of technology enhancement and development, the amount and timing of our license and royalty revenues could be materially affected.

*Allowance for sales returns.* We maintain an allowance for estimated product returns by our customers. We estimate our allowance for sales returns based on our historical return experience, current economic trends, changes in customer demand, known returns we have not received and other estimates. The allowance for sales returns was \$2.0 million, \$1.6 million and \$1.5 million as of December 31, 2004, 2005 and 2006, respectively. If we make different judgments or utilize different estimates, the amount and timing of our revenue could be materially different.

*Allowance for doubtful accounts.* We maintain an allowance for doubtful accounts for estimated losses due to the inability of our customers to make their required payments. We evaluate our allowance for doubtful accounts based on the aging of our accounts receivable, the financial condition of our customers and their payment history, our historical write-off experience and other estimates. If we were to make different judgments of the financial condition of our customers or the financial condition of our customers were to deteriorate additional allowances may be required. The allowance for doubtful accounts was \$1.2 million, \$758,000 and \$112,000 as of December 31, 2004, 2005 and 2006, respectively.

*Allowance for excess and obsolete inventory and lower of cost or market.* Our 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 fluctuate substantially. The value of our inventory is dependent on our estimate of average future selling prices, and, if average selling prices are lower than our estimate, we may be required to reduce 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. We maintain allowance for inventory for potentially excess and obsolete inventories and those inventories carried at costs that are higher than their market values. We review on-hand inventory including inventory held at the logistic center for potential excess, obsolete and lower of cost or market exposure and adjust the level of inventory reserve accordingly. Some of our customers have requested that we ship them product that has a finished goods date of manufacture that is less than one year old. In the event that this becomes a common requirement, it may be necessary for us to provide for an additional allowance for our on-hand finished goods inventory with a date of manufacture of greater than one year old, which could result in additional inventory write-downs. Our allowance for excess and obsolete inventories includes an allowance for our on-hand finished goods inventory with a date of manufacture of greater than two years old and for certain products with a date of manufacture of greater than one year old. For the obsolete inventory analysis, we review inventory items in detail and consider date code, customer base requirements, known product defects, planned or recent product

revisions, end of life plans and diminished market demand. If we determine that market conditions are less favorable than those currently projected by management, such as an unanticipated decline in average selling prices or demand not meeting our expectations, additional inventory write-downs may be required. The allowance for excess and obsolete inventories and lower of cost or market reserves was \$40.5 million, \$51.8 million and \$27.8 million as of December 31, 2004, 2005 and 2006, respectively.

*Provision for adverse purchase commitments.* We maintain a provision for adverse purchase commitments for in process orders at our vendors when we have recorded lower of cost or market valuation provision against our on-hand inventory. Once production has begun against our purchase orders, we are committed to purchasing the inventory or, if we cancel the order, we are liable for all costs incurred up to the time of cancellation. If we have written down our on-hand inventory of the ordered product for lower of cost or market valuations, we must consider the impact to in process inventory at our vendor. We evaluate our in process orders to determine the impact of canceling the order and the impact of purchasing the inventory at a cost higher than the estimated current market value. If we determine that market conditions become less favorable than those currently projected by management, such as an unanticipated decline in average selling prices or demand not meeting our expectations, additional inventory write-downs may be required when the inventory is purchased. The recorded provision for adverse purchase commitments was \$8.3 million, \$1.8 million and \$119,000 as of December 31, 2004, 2005 and 2006, respectively.

*Warranty accrual.* Our products are generally subject to warranty and we provide for the estimated future costs of repair, replacement or customer accommodation upon shipment of the product in the accompanying statements of operations. Our warranty accrual is estimated based on historical claims compared to historical revenues and assumes that we will replace products subject to a claim. For new products, we use our historical percentage for the appropriate class of product. Should actual product failure rates differ from our estimates, revisions to the estimated warranty liability would be required. The recorded value of our warranty accrual was \$803,000 and \$298,000 as of December 31, 2005 and 2006, respectively.

*Litigation losses.* From time to time, we are also involved in legal actions arising in the ordinary course of business. We have incurred certain costs associated with defending these matters. There can be no assurance that shareholder class action complaints, shareholder derivative complaints or other third party assertions will be resolved without costly litigation, in a manner that is not adverse to our financial position, results of operations or cash flows or without requiring royalty payments in the future, all of which may adversely impact net income. As of December 31, 2006, no estimate can be made of the possible loss or possible range of loss associated with the resolution of these contingencies and therefore we have not booked any accrual for such costs. If additional information becomes available such that we can estimate with a reasonable degree of certainty that there is a possible loss or possible range of loss associated with these contingencies, then we would record the minimum estimated liability, such costs or estimates could materially impact our results of operations and financial position.

*Valuation of equity investments.* We hold minority interests in companies having operations in the semiconductor industry. We record an investment impairment charge when we believe an investment has experienced a decline in value that is other than temporary. Future adverse changes in market conditions or poor operating results in these companies could result in losses or an inability to recover the carrying value of the investments, thereby possibly requiring an impairment charge in the future. The carrying value of our equity investments was \$121.7 million, \$135.2 million and \$113.6 million as of December 31, 2004, 2005 and 2006, respectively. We recorded impairment charges of \$509,000, \$605,000 and \$44.1 million for the years ended December 31, 2004, 2005 and 2006, respectively.

Investments in non-marketable equity securities are inherently risky, and a number of these companies are likely to fail. Their success is dependent on product development, market acceptance,

operational efficiency, and other key business success factors. In addition, depending on their future prospects and market conditions, they may not be able to raise additional funds when needed or they may receive lower valuations, with less favorable investment terms than in previous financings, and the investments would likely become impaired.

We review our investments quarterly for indicators of impairment; however, for non-marketable equity securities, the impairment analysis requires significant judgment to identify events or circumstances that would likely have a significant adverse effect on the fair value of the investment. The indicators that we use to identify those events or circumstances include (a) the investee's revenue and earnings trends relative to predefined milestones and overall business prospects; (b) the technological feasibility of the investee's products and technologies; (c) the general market conditions in the investee's industry or geographic area, including adverse regulatory or economic changes; (d) factors related to the investee's ability to remain in business, such as the investee's liquidity, debt ratios, and the rate at which the investee is using its cash; and (e) the investee's receipt of additional funding at a lower valuation. Investments identified as having an indicator of impairment are subject to further analysis to determine if the investment is other than temporarily impaired, in which case the investment is written down to its impaired value and a new cost basis is established. When an investee is not considered viable from a financial or technological point of view, we write off the investment, since we consider the estimated fair value to be nominal. If an investee obtains additional funding at a valuation lower than our carrying amount or requires a new round of equity funding to stay in operation and the new funding does not appear imminent, we presume that the investment is other than temporarily impaired, unless specific facts and circumstances indicate otherwise.

*Stock-based compensation.* Effective January 1, 2006, we implemented SFAS No. 123(R) with regard to equity based compensation. As such, we began accounting for stock options and shares issued under our employee stock purchase plan or ESPP, under SFAS No. 123(R), which requires the recognition of the fair value of equity based compensation. The fair value of stock options and ESPP shares are estimated using a Black-Scholes option valuation model. This model requires us to make subjective assumptions in implementing SFAS No. 123(R), including expected stock price volatility, and estimated life of each award. The fair value of equity-based awards is amortized over the requisite service period, generally the vesting period of the award, and we have elected to use the accelerated method. We make quarterly assessments of the adequacy of the additional paid-in capital pool, or APIC pool, to determine if there are any tax shortfalls which require recognition in the condensed consolidated income statements. Prior to the implementation of SFAS No. 123(R), we accounted for stock options and ESPP shares under the provisions of APB No. 25 and made pro forma footnote disclosures as required by SFAS No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure*, which amended SFAS No. 123 *Accounting for Stock-Based Compensation*. Pro forma net income and pro forma net income per share disclosed in the footnotes to the condensed consolidated financial statements were estimated using a Black-Scholes option valuation model.

We use historical volatility as we believe it is more reflective of market conditions and a better indicator of volatility. We use the simplified calculation of expected life described in the SEC's Staff Accounting Bulletin No. 107. If we determined that another method used to estimate expected volatility was more reasonable than our current methods, or if another method for calculating these input assumptions was prescribed by authoritative guidance, the fair value calculated for share-based awards could change significantly. Higher volatility and longer expected lives result in an increase to share-based compensation determined at the date of grant.

*Accounting for income taxes.* We currently maintain a full valuation allowance on our net deferred tax assets. The valuation allowance was determined in accordance with the provisions of SFAS No. 109 which requires an assessment of both positive and negative evidence when determining whether it is more likely than not that deferred tax assets are recoverable; such assessment is required on a jurisdiction by jurisdiction basis. Expected future U.S. losses represented sufficient negative evidence

under SFAS No. 109 and accordingly, a full valuation allowance was recorded against U.S. deferred tax assets. We intend to maintain a full valuation allowance on the U.S. deferred tax assets until sufficient positive evidence exists to support reversal of the valuation allowance. During 2005 and 2006, we maintained a full valuation allowance on our deferred tax assets. At December 31, 2004, 2005 and 2006 the valuation allowance against our deferred tax assets was \$45.2 million, \$49.9 million and \$34.7 million, respectively.

### Liquidity and Capital Resources

	Year Ended December 31, (as adjusted and restated)		
	2004	2005	2006
Cash provided by (used in):			
Operating activities	\$ (13,992)	\$ (16,495)	\$ 80,901
Investing activities	\$ (26,012)	\$ 52,799	\$ (57,740)
Financing activities	\$ (8,881)	\$ 5,713	\$ 431

*Operating activities.* The major contributing factors to our sources and uses of operating cash during 2006 were our net loss of \$20.8 million, offset by a \$18.0 million reduction of inventories due to changes in average levels of carried inventory and a decrease in receivables of \$12.4 million as a result of payments from our customers. Net income was also affected by non-cash items in 2006, including \$44.1 million of impairments charges from our write downs of GSMC and Nanotech, Inc., a \$12.2 million gain on the sale of PTI shares, stock-based compensation expense of \$7.9 million, depreciation and amortization expense of \$10.0 million, and a \$15.2 million charge to our inventory and adverse purchase commitments provision.

Our operating activities used cash of \$16.5 million for the year ended December 31, 2005. Our net loss of \$26.6 million for the year included non-cash charges of \$36.5 million for provision against inventory, \$10.0 million of depreciation and amortization, \$1.7 million for purchasing in process research and development and \$2.1 million for the provision of sales returns. In addition to our net loss, the primary usage of cash related to an increase in trade accounts receivable of \$20.4 million, decreased accounts payable from related and unrelated parties of \$20.7 million and a decrease in accrued expenses and other liabilities of \$12.4 million.

For 2004, cash used in operating activities included an increase in inventory of \$133.5 million to support increased sales activities and forecast customer demands, a \$7.1 million increase in trade receivables from unrelated parties due to increased revenues and increases in other assets and deferred revenues of \$3.7 million. Cash generated from operating activities included a net income of \$26.7 million, a decrease in trade receivables from related parties of \$8.1 million due mainly to decreased payment terms with our logistic center, SPT, an increase in related and unrelated trade accounts payable of \$37.8 million due to increased purchases of inventories, and an increase in accrued expenses and other liabilities of \$1.4 million. Non-cash adjustments related to a provision for excess and obsolete inventories, write down of inventory to lower of cost or market and adverse purchase commitments of \$36.3 million, depreciation and amortization expense of \$7.4 million, in-process research and development of \$5.9 million, a provision for sales returns and doubtful accounts of \$2.2 million and a \$1.5 million operating lease impairment charge.

*Investing activities.* For 2006, the primary uses of cash from investing activities were \$96.6 million used for the purchase of other available-for-sale instruments and \$18.9 million in cash to purchase additional equity securities including \$15.9 million for additional shares of ACET. In addition, we used \$6.3 million during the year to purchase fixed assets. These uses of cash were partially offset by the receipt of \$64.4 million in cash from the sales and maturities of available-for-sale equity investments.

## Edgar Filing: SILICON STORAGE TECHNOLOGY INC - Form 10-K

Our investing activities provided cash of \$52.8 million for the year of 2005. Cash provided by investing activities in 2005 was primarily attributable to \$89.0 million of cash from the net sales and maturities of available-for-sale investments, offset by the purchase of \$22.0 million in available-for-sale investments, \$7.4 million net cash used in the acquisition of Actrans and the acquisition of a minority interest of Emosyn, and \$6.4 million in capital expenditures.

During 2004, our investing activities used cash of \$26.0 million primarily due to investments in equity securities of GSMC, ACET, Nanotech, PCT, PTI and Insyde of \$33.2 million, \$4.0 million, \$3.8 million, \$1.7 million, \$723,000 and \$133,000, respectively, and the acquisitions of Emosyn and G-Plus which used cash of \$16.0 million and \$4.6 million, respectively. Investing activities also used cash for purchases of available for sale investments and restricted cash of \$47.6 million and purchases of property and equipment of \$8.0 million. Sales and maturities of available for sale investments provided cash from investing activities of \$91.9 million.

*Financing activities.* Cash from financing activities in 2006 related primarily to the issuance of common stock under our employee stock purchase plan and the exercise of employee stock options of \$2.7 million offset by capital lease payments of \$1.5 million and \$857,000 in debt repayments.

Our financing activities provided cash of \$5.7 million during 2005. Cash generated from financing activities primarily related to the borrowing against the line of credit of \$3.0 million, the issuance of common stock under the employee stock purchase plan and the exercise of employee stock options totaling \$3.7 million, partially offset by debt repayments of \$439,000 and repayments on our line of credit of \$575,000.

During 2004, the repurchase of our common stock used cash of \$14.9 million and the issuance of shares of common stock issued under our employee stock purchase plan and the exercise of employee stock options provided cash of \$5.5 million. Repayment of loans used cash of \$393,000 and minority interest capital contributions provided cash of \$820,000.

Principal sources of liquidity at December 31, 2006 consisted of \$139.8 million of cash, cash equivalents, and short-term available-for-sale investments.

### *Contractual Obligations and Commitments*

*Purchase Commitments.* As of December 31, 2006 we had outstanding purchase commitments with our foundry vendors of \$20.2 million for delivery in 2007. We have recorded a liability of \$119,000 for related adverse purchase commitments.

*Lease Commitments.* We have long-term, non-cancelable building lease commitments. In 2004, we recorded charges to other operating expense of \$1.5 million relating to operating leases for an unoccupied building. These charges represent the estimated difference between the total discounted future sublease income and our discounted lease commitments relating to these buildings.

Future payments due under building lease, purchase commitments and other contractual obligations as of December 31, 2006 (in thousands):

	<b>Total</b>	<b>Less than 1 year</b>	<b>1 - 3 years</b>	<b>3 - 5 years</b>	<b>More than 5 years</b>
Capital leases	\$ 2,696	\$ 1,221	\$ 1,475	\$	\$
Operating leases	11,640	3,562	6,793	1,015	270
Purchase commitments	20,245	20,245			
<b>Total</b>	<b>\$ 34,581</b>	<b>\$ 25,028</b>	<b>\$ 8,268</b>	<b>\$ 1,015</b>	<b>\$ 270</b>

*Credit Facilities*

On August 11, 2006, we entered into a 1-year loan and security agreement with Cathay Bank, a U.S. bank, for a \$40.0 million revolving line of credit all of which was available to us as of December 31, 2006. The loan agreement was amended in August 2007 to mature in October 2007 as well as waive covenants, which we were in violation of, requiring us to file timely SEC documents Form 10-K for December 31, 2006 as well as Forms 10-Q for the quarters ending March 31, 2007, June 30, 2007 and September 30, 2007. We did not renew this line after its expiration. The line of credit was intended to be used for working capital but there are no restrictions in the agreement as to how the funds may be used. The interest rate for the line of credit was 1% below the prime rate reported from time to time by the Wall Street Journal, Western Edition (8.25% at December 31, 2006). The line of credit was collateralized by substantially all of our assets other than intellectual property. The agreement contained certain financial covenants, including the levels of qualifying accounts receivable and inventories, which could limit the availability of funds under the agreement. As of December 31, 2006, a standby letter of credit in the amount of \$8.0 million was issued against the line as collateral for a line of credit with Bank of America in China. We were not in compliance with certain covenants requiring the timely filing of U.S. GAAP financial statements as of December 31, 2006.

On September 15, 2006, SST China Limited, a wholly-owned subsidiary of SST, entered into a 10-month facility agreement with Bank of America, N.A. Shanghai Branch, a U.S. bank, for RMB 60.8 million revolving line of credit, or approximately \$8 million U.S. dollars. This line expired and was replaced in August 2007, when SST China Limited entered into a one year facility agreement with Bank of America, N.A. Shanghai Branch for RMB 58.40 million revolving line of credit. The line of credit will be used for working capital but there are no restrictions in the agreement as to how the funds may be used. The interest rate for the line of credit is 90% of People's Bank of China's base rate (6.21% at September 30, 2007). This facility line is guaranteed by the parent company, Silicon Storage Technology, Inc. We are required to meet certain financial covenants, including have a ratio of the funded debt to EBITA less than 2.0. If not, we have to deposit with Bank of America cash collateral at all times in an amount equal to the outstanding principal balance. As of September 30, 2007, SST China Limited has drawn RMB 32 million at the interest rate of 5.427%.

*Off-Balance Sheet Arrangements.*

At December 31, 2005 and 2006, we did not have any off-balance sheet arrangements or relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purposes entities, which are typically established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes.

*Operating Capital Requirements.*

We believe that our cash balances, together with funds we expect to generate from operations, will be sufficient to meet our projected working capital and other cash requirements through at least the next twelve months. However, there can be no assurance that future events will not require us to seek additional borrowings or capital and, if so required, that such borrowing or capital will be available on acceptable terms. Factors that could affect our short-term and long-term cash used or generated from operations and as a result, our need to seek additional borrowings or capital include:

the average selling prices of our products;

customer demand for our products;

the need to secure future wafer production capacity from our suppliers;

the timing of significant orders and of license and royalty revenue;

merger, acquisition or joint venture projects;

investments in strategic business partners;

unanticipated research and development expenses associated with new product introductions; and

the outcome of ongoing litigation.

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

### Recent Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board, or FASB, issued SFAS No. 157, *Fair Value Measurements*, or SFAS No. 157. SFAS No. 157 defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles, and expands disclosures about fair value measurements. This statement does not require any new fair value measurements; rather, it applies under other accounting pronouncements that require or permit fair value measurements. The provisions of this statement are to be applied prospectively as of the beginning of the fiscal year in which this statement is initially applied, with any transition adjustment recognized as a cumulative-effect adjustment to the opening balance of retained earnings. The provisions of SFAS No. 157 are effective for the fiscal years beginning after November 15, 2007; and we determined upon adoption of this standard as of January 1, 2008 that it did not have a material impact on our consolidated financial statements.

In September 2006, the SEC issued Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*, or SAB No. 108, to eliminate the diversity of practice surrounding how public companies quantify financial statement misstatements. Traditionally, there have been two widely-recognized methods for quantifying the effects of financial statement misstatements: the "roll-over" method and the "iron curtain" method. The roll-over method focuses primarily on the impact of a misstatement on the income statement, including the reversing effect of prior year misstatements, but its use can lead to the accumulation of misstatements in the balance sheet. The iron-curtain method, on the other hand, focuses primarily on the effect of correcting the period-end balance sheet with less emphasis on the reversing effects of prior year errors on the income statement. In SAB No. 108, the SEC Staff established an approach that requires quantification of financial statement misstatements based on the effects of the misstatements on each financial statement and the related financial statement disclosures. This model is commonly referred to as a "dual approach" because it requires quantification of errors under both the iron curtain and the roll-over methods. The adoption of SAB No. 108 did not have an impact on our consolidated financial statements.

In July 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes, an Interpretation of FASB Statement No. 109*, or FIN No. 48. FIN No. 48 provides guidance on the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN No. 48 requires that we recognize in the financial statements the benefit of a tax position if that position will more likely than not be sustained on audit, based on the technical merits of the position. FIN No. 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosures, and transition provisions. FIN No. 48 is effective for fiscal years beginning after December 15, 2006. We have evaluated the effect of FIN No. 48 and we believe that adoption of this accounting principle will result in a decrease to our accumulated retained earnings in the first quarter of 2007 of approximately \$3.2 million.



## Edgar Filing: SILICON STORAGE TECHNOLOGY INC - Form 10-K

In July 2006, the FASB issued EITF Issue No. 06-3, *How Taxes Collected from Customers and Remitted to Governmental Authorities Should be Presented in the Income Statement (that is, Gross versus Net Presentation)*. The adoption of EITF No. 06-3 did not have an impact on our consolidated financial statements. Our accounting policy has been to present the above mentioned taxes on a net basis, thus they are excluded from revenues.

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

In accordance with FASB Staff Position No. FAS 123(R)-3, *Transition Election Related to Accounting for Tax Effects of Share-based Payment Awards*, as of December 31, 2006, we elected to use the long-form method to establish the beginning balance of the additional paid-in capital pool related to the tax effects of employee stock-based awards granted prior to the adoption of SFAS No. 123(R). We also elected to use the "with and without" approach as described in EITF Topic No. D-32 in determining the order in which tax attributes are utilized. As a result, we will recognize a tax benefit from stock-based awards in additional paid-in capital only if an incremental tax benefit is realized after all other tax attributes currently available to us have been utilized.

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

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

### **Item 7A. Quantitative and Qualitative Disclosures about Market Risk**

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

these countries. If we consider the value of these companies to be impaired, we will write off, or expense, some or all of our investments. In 2005 and 2006, we recorded equity impairments of \$605,000 and \$44.1 million, respectively.

At any time, fluctuations in interest rates could affect interest earnings on our cash, cash equivalents and short-term investments, or the fair value of our investment portfolio. A 10% move in interest rates as of December 31, 2006 would have an immaterial effect on our financial position, results of operations and cash flows. Currently, we do not hedge these interest rate exposures. As of December 31, 2006, the carrying value of our available-for-sale investments approximated fair value. The table below presents the carrying value and related weighted average interest rates for our unrestricted and restricted cash, cash equivalents and available-for-sale investments as of December 31, 2006 (in thousands):

	<b>Carrying Value</b>	<b>Interest Rate</b>
Cash and cash equivalents variable rate	\$ 100,973	4.6%
Short-term available-for-sale investments fixed rate	38,835	5.3%
Long-term available-for-sale investments fixed rate	7,891	5.3%
	<b>\$ 147,699</b>	<b>4.8%</b>

#### **Item 8. Financial Statements and Supplementary Data**

The consolidated financial statements are included in a separate section of this Annual Report.

##### ***Supplementary Data: Selected Consolidated Quarterly Data***

The following tables present our unaudited consolidated statements of operations data for each of the eight quarters in the period ended December 31, 2006. The data for the consolidated statements of operation for the eight quarters below have been restated, as necessary to reflect the impact of the stock-based compensation adjustments as well as adjustments required by changing from the cost method of accounting for our investment in ACET to the equity method. In our opinion, this information has been presented on the same basis as the audited consolidated financial statements included in a separate section of this report, and all necessary adjustments, consisting only of normal recurring adjustments, have been included in the amounts below to present fairly the unaudited quarterly results when read in conjunction with the audited consolidated financial statements and related notes. The operating results for any quarter should not be relied upon as necessarily indicative of results for any future period. We expect our quarterly operating results to fluctuate in future periods due to a variety of reasons, including those discussed in Item 1A. "Risk Factors." The information presented in the following tables has been adjusted to reflect the restatement of our financial results, which is more fully described in the Explanatory Note immediately preceding Item 1. "Business" and in Note 2. "Restatement of Consolidated Financial Statements" to our consolidated financial statements of this Annual Report on Form 10-K.

## Edgar Filing: SILICON STORAGE TECHNOLOGY INC - Form 10-K

We have not amended our previously-filed Annual Reports on Form 10-K or Quarterly Reports on Form 10-Q for the periods affected by this restatement.

	Quarter Ended			
	March 31, 2005	June 30, 2005	September 30, 2005	December 31, 2005
	As Adjusted and Restated	As Adjusted and Restated	As Adjusted and Restated	As Adjusted and Restated
	(in thousands, except per share data)			
<b>Net revenues:</b>				
Product revenues	\$ 79,270	\$ 84,882	\$ 107,724	\$ 122,220
License revenues	7,045	8,417	10,348	10,992
<b>Total net revenues</b>	<b>\$ 86,315</b>	<b>\$ 93,299</b>	<b>\$ 118,072</b>	<b>\$ 133,212</b>
Gross profit	\$ 13,088	\$ 11,238	\$ 19,072	\$ 35,084
Income (loss) from operations	\$ (10,568)	\$ (19,043)	\$ (5,663)	\$ 11,141
Net income (loss)	\$ (11,178)	\$ (20,238)	\$ (5,272)	\$ 10,064
Net income (loss) per share basic	\$ (0.11)	\$ (0.20)	\$ (0.05)	\$ 0.10
Net income (loss) per share diluted	\$ (0.11)	\$ (0.20)	\$ (0.05)	\$ 0.10

	Quarter Ended			
	March 31, 2006	June 30, 2006	September 30, 2006	December 31, 2006
	As Adjusted and Restated	As Adjusted and Restated	As Restated	
	(in thousands, except per share data)			
<b>Net revenues:</b>				
Product revenues	\$ 100,303	\$ 98,938	\$ 107,510	\$ 108,690
License revenues	10,228	8,791	8,508	9,541
<b>Total net revenues</b>	<b>\$ 110,531</b>	<b>\$ 107,729</b>	<b>\$ 116,018</b>	<b>\$ 118,231</b>
Gross profit	\$ 33,672	\$ 27,413	\$ 30,310	\$ 27,471
Income from operations	\$ 5,402	\$ 1,251	\$ 6,025	\$ 3,443
Net income (loss)	\$ 12,145	\$ 1,178	\$ 5,366	\$ (39,466)
Net income (loss) per share basic	\$ 0.12	\$ 0.01	\$ 0.05	\$ (0.38)
Net income (loss) per share diluted	\$ 0.12	\$ 0.01	\$ 0.05	\$ (0.38)

We recorded inventory valuation adjustments of \$10.8 million, \$12.9 million, \$8.4 million and \$5.2 million in the first, second, third and fourth quarters of 2005, respectively due to a decline in the pricing of several of our products and excess inventories. We recorded a \$2.9 million charge related to in-process R&D expense involving the acquisition of Actrans and the settlement of the Atmel patent litigation case in the second quarter of 2005. In the fourth quarter of 2005, we recorded an asset impairment charge of \$2.2 million relating to one of our equity investments due to a subsequent lower-priced round of equity financing by the investee.

In the first quarter of 2006, we realized a \$12.2 million gain on the sale of one of our investment in PTI. Also during the first quarter of 2006, we recorded an impairment charge of \$3.5 million in our investment in Nanotech Inc. In the fourth quarter of 2006, we recorded an impairment charge of \$40.6 million in our investment in GSMC. We recorded stock-based compensation expense of \$2.0 million, \$1.8 million, \$2.3 million and \$2.0 million in the first, second, third and fourth quarters of 2006, respectively. We recorded inventory valuation adjustments of \$1.7 million, \$6.7 million, \$3.4 million and \$3.0 million in the first, second, third and fourth quarters of 2006, respectively.

The following tables reflect, as necessary, the impact of the stock-based compensation adjustments as well as adjustments required by changing from the cost method of accounting for our investment in ACET to the equity method on our previously reported Consolidated Statement of Operations and Balance Sheets.



Edgar Filing: SILICON STORAGE TECHNOLOGY INC - Form 10-K

Consolidated Statement of Operations

Three months ended March 31, 2005

	As previously reported	Adjustments(1)	As Adjusted	Adjustments(2)	As Adjusted and Restated
<b>Net revenues:</b>					
Product revenues unrelated parties	\$ 37,621	\$	\$ 37,621	\$	\$ 37,621
Product revenues related parties	41,649		41,649		41,649
License revenues unrelated parties	6,943		6,943		6,943
License revenues related parties	102		102		102
	86,315		86,315		86,315
<b>Cost of revenues:</b>					
Cost of revenues unrelated parties	32,441		32,441		32,441
Cost of revenues related parties	41,281		41,281	(495)	40,786
	73,722		73,722	(495)	73,227
<b>Gross profit</b>	<b>12,593</b>	<b></b>	<b>12,593</b>	<b>495</b>	<b>13,088</b>
<b>Operating expenses:</b>					
Research and development	11,965		11,965	(594)	11,371
Sales and marketing	7,340		7,340	(142)	7,198
General and administrative	6,702		6,702	(1,615)	5,087
	26,007		26,007	(2,351)	23,656
<b>Income (loss) from operations</b>	<b>(13,414)</b>	<b></b>	<b>(13,414)</b>	<b>2,846</b>	<b>(10,568)</b>
Interest income	306		306		306
Dividend income	21		21		21
Other income (expense), net	(126)	119	(7)		(7)
Interest expense	(21)		(21)	57	36
	(13,234)	119	(13,115)	3,231	(10,212)
Income (loss) before provision for (benefit from) income taxes, pro rata share of loss from equity investments and minority interest					
Provision for income taxes	746		746	(69)	677
Minority interest	(84)		(84)		(84)
	(13,896)	119	(13,777)	3,300	(10,805)
Income (loss) before pro rata share of loss from equity investments					
Pro rata share of loss from equity investments		373	373		373
	(13,896)	(254)	(14,150)	3,300	(11,178)
<b>Net income (loss)</b>	<b>\$ (13,896)</b>	<b>\$ (254)</b>	<b>\$ (14,150)</b>	<b>\$ 3,300</b>	<b>\$ (11,178)</b>
Net income (loss) per share basic	\$ (0.14)	\$	\$ (0.14)	\$ 0.03	\$ (0.11)
Shares used in per share calculation basic	97,820		97,820		97,820