DESWELL INDUSTRIES INC
Form 20-F
July 14, 2017

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 20-F

(Mark one)

o REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR (g) OF THE SECURITIES EXCHANGE ACT OF 1934

OR

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

For the fiscal year ended March 31, 2017

OR

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

For the transition period from _________ to___________

OR

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

Date of event requiring this shell company report

For the transition period from _________ to___________

Commission File Number: 001-33900

DESWELL INDUSTRIES, INC.
(Exact name of registrant as specified in its charter)

British Virgin Islands (Jurisdiction of incorporation or organization)	Herman Wong, Chief Financial Officer, Telephone: 853-28-322096; fax: 853-28-323265 E-mail: hermanwong@jetcrown.net
10B, Edificio Associacao Industrial De Macau 32 Rua do Comandante Mata e Oliveira, Macao Special Administrative Region, PRC (Address of Principal Executive Offices)	10B, Edificio Associacao Industrial De Macau 32 Rua do Comandante Mata e Oliveira, Macao Special Administrative Region, PRC (Name, Telephone, E-mail and/or Facsimile number and Address of Company Contact Person)

Securities registered or to be registered pursuant to Section 12(b) of the Act: Common shares, no par value

Securities registered or to be registered pursuant to Section 12(g) of the Act: NONE

Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act: NONE

As of March 31, 2017, there were 15,885,239 common shares of the registrant outstanding.

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

If this report is an annual or transition report, indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 oYes **þ**No

Note – Checking the box above will not relieve any registrant required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 from their obligations under those Sections.

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.	**þ**Yes oNo
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).	**þ**Yes oNo

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 q Accelerated filer q Non-accelerated filer þ

Indicate by check mark which basis of accounting the registrant has used to prepare the financial statements included in this filing:

U.S. GAAP þ International Financial Reporting Standards as issued by the International Accounting Standards Board o Other o

If “Other” has been checked, indicate by check mark which financial statement item the registrant has elected to follow: Item 17 o Item 18 o

If this is an annual report, indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). oYes þNo

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INTRODUCTION

This Annual Report on Form 20-F contains forward-looking statements. These statements are subject to certain risks and uncertainties that could cause actual results to differ materially from those anticipated in the forward-looking statements. Factors that might cause such a difference include, but are not limited to those discussed in the section entitled Risk Factors under Item 3 “Key Information.”

Readers should not place undue reliance on forward-looking statements, which reflect management’s view only as of the date of this Annual Report. The Company undertakes no obligation to revise these forward-looking statements to reflect subsequent events or circumstances. Readers should also carefully review the risk factors described in other documents the Company files from time to time with the Securities and Exchange Commission.

Except where the context otherwise requires and for purposes of this Report only:

- “we,” “us,” “our company,” “our,” the “Company” or “Deswell” refers to Deswell Industries, Inc. and, in the context of describing our operations, also include our operating subsidiaries;
- “shares” refer to our common shares, no par value;
- “China” or “PRC” refers to the People’s Republic of China, excluding Taiwan, Hong Kong and Macao;
- “Hong Kong” refers to the Hong Kong Special Administrative Region of the People’s Republic of China;
- “Macao” refers to the Macao Special Administrative Region of the People’s Republic of China;
- “BVI” refers to the British Virgin Islands;
- all references to:
    - renminbi,”“RMB” or yuan are to the legal currency of China, of which the yuan is the base unit;
    - “HK dollars” or “HK$” are to the legal currency of Hong Kong;
    - “MOP$” are to the legal currency of Macao;
    - “U.S. dollars,”“dollars,”“$” or “U.S.$” are to the legal currency of the United States; and
    - “fiscal year,” e.g., “fiscal 2017,” are to our year ended March 31 of the year(s) indicated.

FINANCIAL STATEMENTS AND CURRENCY PRESENTATION

The Company prepares its consolidated financial statements in accordance with generally accepted accounting principles in the United States of America and publishes such statements in United States dollars. See “Report of Independent Registered Public Accounting Firm” included elsewhere herein. The Company publishes its financial statements in United States dollars. The functional currency of the Company and its subsidiaries is the U.S. dollar.

PART **I**

Item 1. IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISERS

Not applicable.

Item 2. OFFER STATISTICS AND EXPECTED TIMETABLE

Not applicable.

Item 3. KEY INFORMATION

The selected financial data set forth below should be read in conjunction with our Consolidated Financial Statements and Notes thereto included at page 57 of this Annual Report. The selected Operations Data for each of the three fiscal years in the period ended March 31, 2017, and the Balance Sheet data as of March 31, 2016 and 2017 are derived from our audited Consolidated Financial Statements included in this Annual Report. The selected Operations Data for the years ended March 31, 2013 and 2014, and the Balance Sheet data as of March 31, 2013, 2014, and 2015 are derived from our audited Consolidated Financial Statements, which are not included in this Annual Report.

Selected Financial Data [1]

	(in thousands except per share and statistical data)				
Consolidated Statement of Operations Data:	**Year ended March 31,**				
	2013	2014	2015	2016	2017
Net sales	$53,382	$40,932	$38,076	$44,568	$44,522
Cost of sales	46,171	37,295	33,852	39,775	37,073
Gross profit	7,211	3,637	4,224	4,793	7,449
Selling, general and administrative expenses	10,714	10,257	9,123	9,119	8,856
Other income (expenses), net	233	(214)	93	(1,021)	(696)
Operating loss	(3,270)	(6,834)	(4,806)	(5,347)	(2,103)
Non-operating income, net	2,056	379	2,553	571	3,688
(Loss) income before income taxes	(1,214)	(6,455)	(2,253)	(4,776)	1,585
Income taxes	328	624	207	158	209
(Loss) income from continuing operations, after income taxes	(1,542)	(7,079)	(2,460)	(4,934)	1,376
Loss from discontinued operations, net of tax	(449)	(411)	(348)	—	—
Net (loss) income attributable to Deswell Industries, Inc.	(1,991)	(7,490)	(2,808)	(4,934)	1,376
Other comprehensive income (loss):					
Unrealized gain (loss) on available-for-sale securities[2]	718	57	33	(73)	(3)
Reclassification adjustment in connection with loss on disposal of available-for-sale securities transferred to profit or loss.	—	—	—	—	14
Total comprehensive (loss) income attributable to Deswell Industries, Inc.	$(1,273)	$(7,433)	$(2,775)	$(5,007)	$1,387
Net (loss) income per share attributable to Deswell Industries, Inc.:					
Basic and Diluted:					
(Loss) income from continuing operations per share[3]	$(0.09)	$(0.43)	$(0.15)	$(0.31)	$0.09
Loss from discontinued operations per share[3]	$(0.03)	$(0.03)	$(0.02)	$—	$—
	$(0.12)	$(0.46)	$(0.17)	$(0.31)	$0.09
Weighted average common shares outstanding[3] (shares in thousands)	16,467	16,186	16,056	16,056	16,035
Statistical Data:					
Gross margin from continuing operations	13.5 %	8.9 %	11.1 %	10.8 %	16.7 %

Operating margin from continuing operations	(6.1 %)	(16.7 %)	(12.6 %)	(12.0 %)	(4.7 %)

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Dividends per share	$0.30	$0.22	$0.19	$0.14	$0.105

Balance Sheet Data:

	2013	2014	2015	2016	2017
Working capital	$58,298	$50,868	$45,864	$39,890	$41,307
Total assets	112,565	100,636	96,439	87,571	90,987
Long-term debt, less current portion	—	—	—	—	—
Total debt	—	—	—	—	—
Shareholders' equity	101,576	89,610	84,063	76,808	76,201

(1) Our consolidated financial statements are prepared in accordance with generally accepted accounting principles in the United States of America and are stated in U.S. dollars. See "Financial Statements and Currency Presentation."

(2) See Note 4 of Notes to Consolidated Financial Statements included later in this Report regarding unrealized gain (loss) on available-for-sale securities during the years ended March 31, 2016 and 2017.

(3) Basic loss per share excludes dilution from potential common shares and is computed by dividing loss attributable to Deswell shareholders by the weighted-average number of common shares outstanding for the period. Diluted loss per share reflects the potential dilution from potential common shares.

Risk Factors

We may from time to time make written or oral forward-looking statements. Written forward-looking statements may appear in this document and other documents filed with the Securities and Exchange Commission, in press releases, in reports to shareholders, on our website, and other documents. The Private Securities Litigation Reform Act of 1995 contains a safe harbor for forward-looking statements on which we rely in making such disclosures. In connection with this "safe harbor," we are hereby identifying important factors that could cause actual results to differ materially from those contained in any forward-looking statements made by us or on our behalf. Any such statement is qualified by reference to the following cautionary statements:

We are, and have been, dependent on a few major customers, the loss of, or substantial reduction in orders from, which would substantially harm our business and operating results.

Historically, we have depended, currently depend, and expect to continue to depend, on a small number of customers for a significant percentage of our net sales.During the year ended March 31, 2017,we had three major customers, each accounting for more than 10% of our net sales and together for 33.6% of our net sales. If our major customers experience a decline in the demand for their products as a result of the prevailing economic environment or other factors, the products or services that we provide to them could be reduced or even terminated. The loss of any of our majorcustomers or a substantial reduction in orders from any of them would adversely impact our sales and operating results unless and until we were able to increase sales from other existing customers or add sales from new customers.

Our sales are based on purchase orders and we have no long-term contracts with any of our customers and the percentage of sales to any of our customers has fluctuated in the past and may fluctuate in future. We cannot assure you that present or future customers will not cease using us as the source of the injection-molded plastic parts and components we manufacture, for electronic manufacturing services of electrical products and subassemblies or significantly change, reduce or delay the amount of products and services ordered from us.

Uncertainty and adverse changes in the economy and financial markets have had, and could continue to have, an adverse impact on our business and operating results.

As a result of the recent global economic downturn, many businesses, including those of several of our customers, experienced weaker demand for their products and services. Our customers so affected, in turn, were more conservative in ordering our products and services. There are continuing concerns over price instability, geopolitical issues, availability and cost of credit, stability of financial markets and sovereign nations. Uncertainty or adverse changes in the economy could negatively impact:

· the demand for our customers' products,
· the amount, timing and stability of their orders to us,

- the financial strength of our customers and suppliers,
- our customers' and suppliers' ability or willingness to do business with us,
- our suppliers' and customers' ability to fulfill their obligations to us,
- the ability of our customers, our suppliers or us to obtain credit, secure funds or raise capital, or
- the prices at which we can sell our products and services,

which, in turn, could adversely affect

- our ability to manage inventory levels effectively or collect receivables,
- our cash flow position,
- our net sales, gross margins and operating results; or
- otherwise adversely impact our results of operations, financial condition and liquidity.

Our gross margins fluctuate from year to year and may be adversely affected by a number of factors.

The following chart shows, for the years indicated, our gross margins from our two principal operating segments and for our company as a whole:

Gross Margins Percentage

We expect gross margins generally and for specific products to continue to fluctuate from year to year. Fluctuations in our margins have been affected, often adversely, and may continue to be affected, by numerous factors, including:

- our cost of raw materials, especially our cost of electronic components due to changes in the prices, availability and long lead time of components and parts needed for the manufacturing of electronic products;
- costs of labor, particularly in recent years, when such costs have increased substantially as a consequence of increasing governmental regulation directed at labor practices and policies;

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- the appreciation of the exchange rate of the RMB, in which we pay our labor and manufacturing costs, against the U.S. dollar, in which we present our financial statements;
- changes in our customer mix or the mix of higher and lower margin products, or a combination of both in any year;
- price increases for products which, for competitive reasons, we choose to allow as concessions in an effort to maintain our customer base;
- increases in value-added taxes as result of changes in the value-added tax policy of the Chinese government for various categories of export products; and
- increased costs to conform our products to consumer and product safety laws and regulations of the various countries in which our products are sold.

If we cannot maintain stability in our gross margins, our operating results could suffer, dividend payments to shareholders may be decreased or eliminated, our financial position may be harmed and our stock price may fall.

We believe we were a passive foreign investment company, or “PFIC,” for our fiscal year ended March 31, 2017 under U.S. income tax laws and may be a PFIC for years after fiscal 2017. If we were a PFIC in fiscal 2017, or are a PFIC in later years, U.S. investors could suffer adverse U.S. federal income tax consequences in such years.

The determination of whether we are a passive foreign investment company, or PFIC, in any taxable year is made on an annual basis after the close of that year and depends on the composition of our income and the nature and value of our assets, including goodwill. Specifically, we will be classified as a PFIC if, after applying relevant look-through rules with respect to the income and assets of subsidiaries, either (i) 75% or more of our gross income for such taxable year is passive income, or (ii) 50% or more of the value of our assets (based on an average of the quarterly values of the assets during such year) is attributable to assets that either produce passive income or are held for the production of passive income (the “PFIC asset test”). Cash and cash equivalents, even if they are part of the working capital of a company, constitute “passive” assets for the purposes of the PFIC asset test.

We believe that we were a PFIC for our year ended on March 31, 2017 and may also be a PFIC in subsequent tax years. If we are a PFIC for any year during a U.S. Holder’s holding period of our common shares, then such U.S. Holder generally could be subject to adverse U.S. tax consequences including the requirement to treat any “excess distribution” received on our common shares, or any gain realized upon a disposition of such common shares, as ordinary income and to pay an interest charge on a portion of such distributions or gain.

Because of the complexity of the issues regarding our classification as a PFIC, U.S. investors are urged to consult their own tax advisors for guidance as to our PFIC status. For further discussion of the adverse U.S. federal income tax consequences arising from the classification as a PFIC, please see “United States Federal Income Tax – Passive Foreign Investment Company (PFIC)” in ITEM 10 Additional Information beginning on page 50 of this Report.

The economy of China has been experiencing significant growth, leading to inflation and increased labor costs. Increases in labor costs of workers in the PRC generally, and in the Province where our manufacturing facilities are located particularly, have had and can be expected to continue to have a material and adverse effect on our operating results.

We generate all revenues from sales of products that we manufacture at our facilities located in Dongguan, Guangdong Province, in the PRC. The economy in China has grown significantly over the past 20 years, which has resulted in an increased inflation and the average cost of labor.

The inflation rate in China rose 1.5% year-on-year in May of 2017. However, the Company’s actual cost of operations has significantly exceeded the overall inflation rate in China. The rapid growth of China’s economy in general has in the past few years increased the Company’s operating costs, including energy prices and labor costs. These increased costs have adversely affected the Company’s cost of operations, caused the Company to increase its prices, and resulted in the loss of some customers.

There is no fixed minimum wage which is applicable to all of China; local governments in China adopt different amounts based on the situation in their area. China’s Guangdong Province, where our manufacturing facilities are located, raised minimum wages by approximately 20% May 2011 and another 19.1% in March 2013.

Effective May 1, 2015, minimum wage levels across Guangdong Province, including Dongguan, where our manufacturing facilities are located, were increased by an average of 15.3%.Since May 1, 2015, there have been no adjustments made to the minimum wage in Guangdong Province.

In China, regional governments are authorized to set their own minimum wages according to local conditions. Increases in wages also result in increases in our and other employer's contributions for various mandatory social welfare benefits for Chinese employees that are based on percentages of their salaries. Continuing material increases in our cost of labor will continue to increase our operating costs and will adversely affect our financial results unless we pass on such increases to our customers by increasing the prices of our products and services. The effect of increases in the prices of our products and services would make our products more expensive in global markets, such as the United States and the European Union. This could result in the loss of customers, who may seek, and be able to obtain, products and services comparable to those we offer in lower-cost regions of the world. If we do not increase our prices to pass on the effect of increases in our labor costs, our margins and financial results would suffer.

Because most of our labor costs are incurred in China and therefore paid in RMB, the adverse effect on our business and financial results from increasing labor costs has historically been exacerbated by the appreciation in the exchange rate to the U.S. dollar, as is discussed in the next risk factor.

Changes in currency exchange rates have and could continue to influence our financial results significantly.

Our sales are mainly in United States dollars and Hong Kong dollars and our expenses are mainly in United States dollars, Hong Kong dollars and Chinese RMB.

The Hong Kong dollar has been pegged to the U.S. dollar at approximately 7.80 and has been relatively stable. The Hong Kong government may not continue to maintain the present currency exchange mechanism, which fixes the Hong Kong dollar at approximately 7.80 to each United States dollar and has not in the past presented a material currency exchange risk. Although announcements by Hong Kong's central bank indicate its intention to maintain the currency peg between the Hong Kong dollar and the U.S. dollar, if Hong Kong does change and follows China to a floating currency system or otherwise changes the exchange rate system of Hong Kong dollars to U.S. dollars, our margins and financial results could be adversely affected.

Between 1994 and July 2005, the market and official RMB rates were unified and the value of the RMB was essentially pegged to the U.S. dollar and was relatively stable. On July 21, 2005, the People's Bank of China adjusted the exchange rate of RMB to the U.S. dollar by linking the RMB to a basket of currencies and simultaneously setting the exchange rate of RMB to U.S. dollars, from 1:8.27, to a narrow band of around 1:8.11.

The chart below illustrates the fluctuations since the July 31, 2005 adjustment of the RMB to the U.S. dollar by showing the exchange ratio at the end of each of Deswell's fiscal years from March 31, 2006 to March 31, 2017. Because most of the Company's labor costs are incurred in China and therefore paid in RMB, the adverse effect on Deswell's business and financial results from increasing labor costs has in previous years been exacerbated by the appreciation in the exchange rate to the U.S. dollar. However, in fiscal 2017, the RMB depreciated relative to the U.S. dollar, with the exchange rate mitigating rather than exacerbating the increasing labor costs experienced by the Company.

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(1) RMB (yuan) to U.S. dollar data presented in this chart are the midpoint rates on March 31 of the year indicated as reported by “Historical Exchange Rates” athttp://www.oanda.com/currency/historical-rates/.

The appreciation and depreciation in the exchange ratio of the RMB to the U.S. dollar increases and decreases, respectively, our costs and expenses to the extent paid in RMB. Of all of the costs and expenses for the PRC entities, which accounted for 98.2% of the Company total, about 52.0%, 47.2%, and 48.9% were in RMB during the years ended March 31, 2015, 2016 and 2017, respectively.

The PRC government may adopt an even more flexible currency policy, which, if adopted, could result in appreciation of the exchange rate of the RMB to the U.S. dollar beyond the appreciation experienced under China’s current system.

If the RMB continues its appreciation to the U.S. dollar under China’s currency exchange system, our operating costs will continue to increase, and if China adopts a different or more flexible system of currency exchange resulting in greater appreciation of the RMB to the U.S. dollar, our operating costs could increase even more. In either event, such appreciation would adversely affect our financial results in a manner similar to the effects we have suffered, and may in the future suffer, as a consequence of our increasing labor costs.

For a discussion of the risks to our business from increases in our costs of labor, please see the risk factor immediately above entitled “The economy of China has been experiencing significant growth, leading to inflation and increased labor costs. Increases in labor costs of workers in the PRC generally, and in the Province where our manufacturing facilities are located particularly, have had and can be expected to continue to have a material and adverse effect on our operating results.”

If OEMs stop or reduce their manufacturing outsourcing, our business could suffer.

Our revenues depend on outsourcing by OEMs to us and to other contract manufacturers for which we manufacture end-products or parts and components. Current and prospective customers continuously evaluate our capabilities against other providers as well as against the merits of manufacturing products themselves. Our business would be adversely affected if OEMs decide to perform these functions internally. Similarly, we depend on new outsourcing opportunities to militate against lost revenues arising from the decline in demand for our customers’ products as a consequence of prevailing global economic conditions, and our business would be adversely affected if we are not successful in gaining additional business from these opportunities or if OEMs do not outsource additional manufacturing business.

We could experience credit problems with our customers, which could adversely impact our operating results and financial condition and could adversely reduce our future revenues.

We manufacture and sell injection-molded plastic parts and components and provide manufacturing services for electrical products and subassemblies to companies and industries that have in the past, and may in the future, experience financial difficulty, particularly in light of recent conditions in the credit markets and the overall worldwide economy. For information on the concentration of our credit risk, see Note 19 of Notes to Consolidated Financial Statements included later in this Report.

If our customers experience financial difficulty, we could have problems recovering amounts owed to us from these customers, or demand for our products and services from these customers could decline. If one or more of our customers, particularly customers to which we have extended substantial credit and which have become material account debtors on our accounts receivables, were to become insolvent or otherwise were unable to pay for the products or services provided by us on a timely basis, or at all, our operating results and financial condition could be adversely affected. Such adverse effects could include one or more of the following:

- provision or increased provision for doubtful accounts,
- a charge for inventory write-offs,
- a reduction in revenue,
- decreases in cash, and
- increases in working capital requirements.

Because material amounts of our funds are held in banks where only limited protection on deposit accounts is required, the failure of any bank in which we deposit our funds could result in a loss of those funds to the extent exceeding the amounts protected and could, depending on the amount involved, affect our ability to continue in business.

At March 31, 2017, we had cash on hand of $8.1 million, time deposits maturing over three months of $5.4 million and time deposits maturing over twelve months of $2.9 million, which were invested in short-term interest bearing investments at banks or other financial institutions. Of that amount, approximately $1.9 million was held in banks and other financial institutions in Hong Kong, $4.7 million in Macao and $9.8 million in the PRC. The Hong Kong government provides deposit protection up to a maximum amount of HK$500,000 (approximately U.S.$64,400 based on the midpoint exchange rate for June 30, 2017 reported by “Historical Exchange Rates” at http://www.oanda.com/currency/ historical-rates/) for each depositor in any individual bank in Hong Kong, and the Macao government provides deposit protection up to a maximum amount of MOP$500,000 (approximately U.S.$64,100 based on the midpoint exchange rate for June 30, 2017 reported by “Historical Exchange Rates” at http://www.oanda.com/currency/ historical-rates/) for each depositor with any individual bank in Macao. We understand that in the event of a bank failure of a bank in the PRC, a PRC-government agency is to provide some, unspecified, protections of deposit accounts to individual depositors. After three interest rate hikes in 2011, there were recommendations in early 2012 from China’s economists that a formal insurance system from China’s central bank is necessary to protect depositors' assets. On May 1, 2015, the new "Deposit Insurance Regulations" became effective in the PRC and provide that the maximum protection would be up to RMB500,000 (including principal and interest) per depositor per insured financial institution. Depending upon the amounts of funds we have on deposit in a Hong Kong, Macao or PRC financial institution that fails, our inability to have immediate access to our cash, and the lack of deposit protection in excess of applicable protection limits, couldimpair our operations, and, if we are not able to access needed funds to pay our suppliers, employees and other creditors, we may be unable tocontinue in business.

Our industry is extremely competitive, with aggressive pricing dynamics, and if we are not able to continue to provide competitive products and services, we may lose business.

We compete with a number of different companies in production of injection-molded plastic parts and components, electrical products and subassemblies and metallic molds and accessories. For example, we compete with Asian-based manufacturers and/or suppliers of injection-molded plastic parts and components, major global electronic manufacturing services ("EMS") providers, other smaller EMS companies that have a regional or product-specific focus, and original design manufacturers with respect to some of the services that we provide. We also compete with our current and prospective customers, who evaluate our capabilities in light of their own capabilities and cost structures. Our market segments are extremely competitive, many of our competitors have achieved substantial market share and many have lower cost structures and greater manufacturing, financial or other resources than we do. We face particular competition from Asian-based competitors, including Taiwanese EMS providers which compete in our end markets. If we are unable to provide comparable manufacturing services and improved products at lower cost than the other companies in our market, our net sales could decline.

Uncertainty and adverse changes in the economy and financial markets may also increase the competitive environment in our market segments which could also impact our operating results. In addition, the EMS industry is currently experiencing excess manufacturing capacity and has seen increased competition. To stay competitive, we have had retired some old machines and reinvested in some state of the art ones in order to best achieve high efficiency, precision and quality.

Nonetheless, the above factors have exerted and will continue to exert additional pressures on pricing for injection-molded plastic parts and components and for our electronic manufacturing services, thereby increasing the competitive pressures in our market segments generally. We may not be able to compete successfully against our current and future competitors, and the competitive pressures we face may have a material adverse effect on us.

We have no long-term contracts to obtain plastic resins and our profit margins and operating results could suffer from an increase in resin prices.

The primary materials used by us in the manufacture of our plastic injection molded products are various plastic resins. The following table shows our cost of plastic resins as a percentage of our cost of plastic products sold and as a percentage of our total costs of goods sold for the years ended March 31, 2015, 2016 and 2017:

We have no long-term contracts with our resin suppliers. Accordingly, our financial performance is dependent to a significant extent on resin markets and the ability to pass through price increases to our customers. The capacity, supply and demand for plastic resins and the petrochemical intermediates from which they are produced are subject to cyclical price fluctuations, including those arising from supply shortages. Consequently, resin prices may fluctuate as a result of changes in natural gas and crude oil prices and the capacity, supply and demand for resin and petrochemical intermediates from which they are produced. Over the past several years, oil prices have experienced significant volatility. In addition, we have found that increases in resin prices are difficult to pass on to our customers. In the past, increases in resin prices have increased our costs of goods sold and adversely affected our operating margins. A significant increase in resin prices in the future could likewise adversely affect our operating margins and results of operations.

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Shortages of components and materials used in our production of electronics products may delay or reduce our sales and increase our costs.

From time to time, we have experienced shortages of some of the electronic components that we need and use in our electronics manufacturing market segment. These shortages can result from strong demand for those components or from problems experienced by suppliers. These unanticipated component shortages could result in curtailed production or delays in production, which may prevent us from making scheduled shipments to customers. Our inability to make scheduled shipments could cause us to experience a reduction in sales, increase in inventory levels and costs, and could adversely affect relationships with existing and prospective customers. Component shortages may also increase our cost of goods sold because we may be required to pay higher prices for components in short supply and redesign or reconfigure products to accommodate substitute components. As a result, component shortages could adversely affect our operating results. Our performance depends, in part, on our ability to incorporate changes in component costs into the selling prices for our products.

Certain of the electronic products we manufacture, particularly those for customers whose orders are widely spaced at irregular intervals for small lots of customized products, require components from single-source or customer-designated suppliers. Shortages of specific components often result in the suppliers allocating available quantities among their customers based on volume and purchasing history. Generally, we lack sufficient bargaining power with these suppliers to assure a stable supply of needed components. Delays in our obtaining, or our inability to obtain, these materials could slow production, delay shipments to our customers, increase our costs and hamper our operating results.

We face inventory risks of obsolescence and impairment charges by providing turnkey manufacturing of electronic products.

We conduct most of the manufacturing of electronic products for our customers on a “turnkey” basis, where we mainly take care of materials procurement, as well as product design and development for customers’ selection and collaboration. Turnkey manufacturing involves greater resource investment and inventory risk management than consignment manufacturing, where the customer provides the components and materials needed to manufacture the products it orders. If we fail to manage our inventory effectively, we may bear the risk of fluctuations in materials costs, scrap and excess inventory, all of which can have an adverse impact on our business, financial condition and results of operations. In addition, delays, cancellations or reductions of orders by our customers could result in an excess of materials. An excess of components and materials would increase our costs of maintaining inventory and may increase the risk of inventory obsolescence and impairment charges, which may increase our costs and decrease operating margins and otherwise harm our operating results.

Periods in which we receive rapid increases in orders with the lengthening of lead times by suppliers could cause a shortage of materials needed for us to fulfill orders received from customers expecting normal or accelerated delivery. A shortage of materials could lengthen production schedules and costs substantially, particularly for orders from our customers placed for short-term or rapid delivery and could force us to seek and purchase needed components at premium prices, which would increase our costs of goods sold and reduce our operating margins.

The Chinese government could change its policies toward or even nationalize private enterprise, which could result in the total loss of our investment in that country.

Our manufacturing facilities are located in China. As a result, our operations and assets are subject to significant political, economic, legal and other uncertainties associated with doing business in China. Over the past several years, the Chinese government has pursued economic reform policies including the encouragement of private economic activity and greater economic decentralization. The Chinese government may not continue to pursue these policies or may significantly alter them to our detriment from time to time without notice. Changes in policies by the Chinese government resulting in changes in laws, regulations, or their interpretation, or the imposition of confiscatory taxation, restrictions on currency conversion or imports and sources of supply could materially and adversely affect us. The nationalization or other expropriation of private enterprises by the Chinese government could result in the total loss of our investment in that country.

There may be a lack of remedies and impartiality under the Chinese legal system that prevents us from enforcing the agreements under which we operate our factories.

We do not own the land on which our factories in China are located. We occupy our manufacturing facilities under land use agreements or under tenancy agreements with the local Chinese government. These agreements may be difficult to enforce in China, which could force us to accept terms that may not be as favorable as those provided in our agreements. Unlike the U.S., China has a civil law system based on written statutes in which judicial decisions have little precedential value. The Chinese government has enacted some laws and regulations dealing with matters such as corporate organization and governance, foreign investment, commerce, taxation and trade. However, their experience in implementing, interpreting and enforcing these laws and regulations is limited, and our ability to enforce commercial claims or to resolve commercial disputes is unpredictable. These matters may be subject to the exercise of considerable discretion by agencies of the Chinese government, and forces unrelated to the legal merits of a particular matter or dispute may influence their determination.

If our business licenses in China were not renewed, we would be required to move our operations out of China, which would impair our financial results, competitiveness and market position and jeopardize our ability to continue operations.

Our activities in China require business licenses, the scope of which is limited to our present activities, and require review and approval of our activities by various national and local agencies of Chinese government. The Chinese government may not continue to approve our activities, grant or renew our licenses or grant or renew licenses to expand our existing activities. Our inability to obtain needed approvals or licenses could prevent us from continuing to conduct operations in China. If for any reason we were required to move our manufacturing operations outside of China, our financial results would be substantially impaired, our competitiveness and market position would be materially jeopardized and we may not be able to continue operations.

Our insurance coverage may not be adequate to cover losses related to major accidents, forces of nature or product liability risks.

Risks associated with our business include risk of damage to our stock in trade, goods and merchandise, furniture and equipment and factory buildings in China. At March 31, 2017, we maintained fire, casualty and theft insurance aggregating approximately $117.6 million covering damages to fixed and movable assets, equipment, manufacturing facilities in China and furniture and fixtures at our facilities. The proceeds of this insurance may not be sufficient to cover material damage to, or the loss of, any of our factories due to fire, severe weather, flood, forces of nature, such as major earthquakes, which are common in China, or other natural disasters. We may experience difficulty or delays in receiving compensation from the insurance companies and may not receive insurance proceeds adequate to compensate us fully for a potential loss. Although we maintain insurance addressing damage to and destruction to our facilities and equipment, we do not have business interruption insurance.

Despite quality assurance measures, there remains a risk that defects may occur in our products. The occurrence of any defects in our products could give rise to liability for damages caused by such defects. They could, moreover, impair the market's acceptance of our products. At March 31, 2017, we had only limited product liability insurance. Although we have not experienced any product quality claims from significant customers, if future claims do arise, costs to defend, adverse judgments or amounts we may be forced to pay in settlement would increase our expenses. If we incur losses which are not covered under our insurance, or the amount of compensation that we receive from the insurer is significantly less than the actual loss, our financial condition and results of operations could be materially and adversely affected.

Payment of dividends by our subsidiaries in the PRC to us is subject to restrictions under PRC law. The new PRC tax law could force us to reduce the amount of dividends we have historically paid to our shareholders or possibly eliminate them or we may decide not pay dividends in the future.

Under PRC law, dividends may be paid only out of distributable profits. Distributable profits with respect to our subsidiaries in the PRC refers to after-tax profits as determined in accordance with accounting principles and financial regulations applicable to PRC enterprises ("China GAAP") less any recovery of accumulated losses and allocations to statutory funds that it is required to make. Any distributable profits that are not distributed in a given year are retained and available for distribution in subsequent years. The calculation of distributable profits under China GAAP differs in many respects from the calculation under U.S. GAAP. As a result, our subsidiaries in PRC may not be able to pay any dividend in a given year as determined under U.S. GAAP. The China tax authorities may require changes in determining income of the Company that would limit its ability to pay dividends and make other distributions. PRC law requires companies, including our PRC subsidiaries, to reserve about 10% of their profits for future development and staff welfare, which amounts are not distributable as dividends. These rules and possible changes to them could restrict our PRC subsidiaries from repatriating funds ultimately to us and our stockholders as dividends.

Under the unified enterprise income tax law (“EIT Law”), dividends payable to foreign investors which are derived from sources within the PRC are subject to income tax at the rate of 10% by way of withholding unless the foreign investors are companies incorporated in countries which have a tax treaty agreement with PRC and the rate agreed by both parties will be applied. As a result of this PRC withholding tax, amounts available to us in earnings distributions from our PRC enterprises have been reduced. Since we derive the funds distributed to shareholders from our subsidiaries in the PRC, the reduction in amounts available for distribution from our PRC enterprises could, depending on the income generated by our PRC subsidiaries, force us to reduce, or possibly eliminate, the dividends we have paid to our shareholders historically. For this reason, or other factors, we may decide not to declare dividends in the future. If we do pay dividends, we will determine the amounts when they are declared and even if we do declare dividends in the future, we may not continue them in any future period.

Under China’s EIT Law, we may be classified as a “resident enterprise” for PRC tax purposes, which may subject us to PRC enterprise income tax for any dividends we receive from our Chinese subsidiaries and to PRC income tax withholding for any dividends we pay to our non-PRC stockholders.

Under the PRC’s EIT Law, an enterprise established outside of China whose “de facto management bodies” are located in China is considered a “resident enterprise” and is subject to the 25% enterprise income tax rate on its worldwide income. The EIT Law and its implementing rules were effective as of January 1, 2008 and represent a milestone in the PRC tax system.

All of our manufacturing operations are conducted and managed in the PRC. Our corporate structure, illustrating our incorporation in BVI and our ownership of companies inside and outside of China, is set forth on page 21 of this Report. If the PRC tax authorities determine that our holding company structure utilizing companies outside of China is a “resident enterprise” for PRC enterprise income tax purposes, we may be subject to an enterprise income tax rate of 25% on our worldwide taxable income. The “resident enterprise” classification also could subject us to a 10% withholding tax on any dividends we pay to our non-PRC stockholders if the relevant PRC authorities determine that such income is PRC-sourced income. If we are classified as a “resident enterprise” and we incur these tax liabilities, our financial results would be negatively impacted accordingly.

Transactions between our subsidiaries may be subject to scrutiny by the PRC tax authorities. A finding that any of our China subsidiaries owe additional taxes, late payment interest or other penalties could adversely affect our operating results materially.

The PRC's EIT Law emphasizes the requirement of an arm's-length basis for transfer pricing transactions between related parties. It requires enterprises with transactions between related parties, such as transactions between our subsidiaries located inside and outside of China, to prepare transfer pricing documentation that includes the basis for determining pricing, the computation methodology and detailed explanations. We could face material and adverse consequences if the PRC tax authorities determine that transactions between our subsidiaries do not represent arm's-length pricing and are thereby deemed tax avoidance, or determine that related documentation does not meet the requirements of the EIT Law. Such determinations could result in increased tax liabilities of the affected subsidiaries and potentially subject them to late payment interest and other penalties.

Controversies affecting China's trade with the United States could harm our operations or depress our stock price.

Historically, the United States has been the major or significant geographical area of our product sales in terms of shipping destinations. While China has been granted permanent most favored nation trade status in the United States, controversies between the United States and China may arise that threaten the status quo involving trade between the United States and China. These controversies could adversely affect our business by, among other things, causing our products in the United States to become more expensive, which could result in a reduction in the demand for our products by customers in the United States. Political or trade friction between the United States and China, whether or not actually affecting our business, could also adversely affect the prevailing market price of our common shares. This risk has increased in recent years as our sales into the United States have accounted for significant amounts of our global sales. The United States was our number two market in our years ended March 31, 2015, March 31, 2016 and March 31, 2017. See Item 4 "Information on the Company – Customers and Marketing"on page 20 of this Report for information regarding our net sales as a percentage of total sales to customers by geographic area.

Restrictions on the convertibility of RMB into foreign currency may limit our ability to transfer excess funds or dividends to the Company's subsidiaries outside China.

Our manufacturing operations are conducted by our subsidiaries located in China and funds are frequently transferred into our subsidiaries in China. Thus, any future restrictions on currency exchanges may limit our ability to transfer excess funds or dividends outside China. Although the PRC government introduced regulations in 1996 to allow greater convertibility of RMB for current account transactions, significant restrictions still remain, including primarily the restriction that foreign-invested enterprises may only buy, sell and/or remit foreign currencies at those banks authorized to conduct foreign exchange business after providing valid commercial documents. The Chinese regulatory authorities may impose more stringent restrictions on the convertibility of RMB, especially with respect to foreign exchange transactions.

Political and economic instability of Hong Kong and Macao could harm our operations.

Our administration and accounting offices are located in Macao, formerly a Portuguese Colony, and some of our customers and suppliers are located in Hong Kong, formerly a British Crown Colony. Sovereignty over Macao and Hong Kong was transferred to China effective on December 20, 1999 and July 1, 1997, respectively. Since their transfers, Macao and Hong Kong have become Special Administrative Regions of China, enjoying a high degree of autonomy except for foreign and defense affairs. Moreover, China's political system and policies are not practiced in Macao or Hong Kong. Under the principle of "one country, two systems," Macao and Hong Kong maintain legal systems that are different from that of China. Macao's legal system is based on the Basic Law of the Macao Special Administrative Region and, similarly, Hong Kong's legal system is based on the Basic Law of the Hong Kong Special Administrative Region. It is generally acknowledged as an open question whether Hong Kong's future prosperity in its role as a hub and gateway to China after China's accession to the World Trade Organization (introducing market liberalization in China) will be diminished. The continued stability of political, economic or commercial conditions in Macao and Hong Kong remain uncertain, and any instability could have an adverse impact on our business.

The PRC's national labor law restricts our ability to reduce our workforce if we conclude that we need to make future reductions.

In June 2007, the National People's Congress of the PRC enacted labor legislation, called the Labor Contract Law, and that law became effective on January 1, 2008. The law formalized workers' rights concerning overtime hours, pensions, layoffs, employment contracts and the role of trade unions. Considered one of the strictest labor laws in the world, among other things, this law requires an employer to conclude an "open-ended employment contract" with any employee who either has worked for the employer for 10 years or more or has had two consecutive fixed-term contracts. An "open-ended employment contract" is in effect a lifetime, permanent contract, which is terminable only in specified circumstances, such as a material breach of the employer's rules and regulations, or for a serious dereliction of duty. Such employment contracts with qualifying workers would not be terminable if, for example, we determined to downsize our workforce in the event of an economic downturn. Under the 2007 law, downsizing by 20% or more may occur only under specified circumstances, such as a restructuring undertaken pursuant to China's Enterprise Bankruptcy Law, or where a company suffers serious difficulties in production and/or business operations. Also, if we lay off more than 20 employees or 10% at one time, we have to communicate with the labor union of our Company and report to the District Labor Bureau. Deswell's entire staff, who are employed to work exclusively within the PRC, is covered by the new law. In response to prevailing business conditions, we reduced our workforce by 10 and 68 during the years ended March 31, 2015 and 2016, respectively. However, we may incur much higher costs under China's Labor Contract Law if we are forced to downsize our workforce in the future. Accordingly, this law can be expected to exacerbate the adverse effect of unfavorable economic conditions on our results of operations and financial condition.

Our customers are dependent on shipping companies for delivery of our products and interruptions to shipping could materially and adversely affect our business and operating results.

Generally, we sell our products F.O.B. Hong Kong or F.O.B. China and our customers are responsible for the transportation of products from Hong Kong or China to their final destinations. Our customers rely on a variety of carriers for product transportation through various world ports. A work stoppage, strike or shutdown of one or more major ports or airports could result in shipping delays materially and adversely affecting our customers, which in turn could have a material adverse effect on our business and operating results. Similarly, an increase in freight surcharges due to rising fuel costs or general price increases could materially and adversely affect our business and operating results.

Protecting, seeking licenses for, or asserting claims over, intellectual property could be costly.

We usually rely on trade secrets, industry expertise and the sharing with us by our customers of their intellectual property. However, there can be no assurance that intellectual property that we use in our business does not violate rights in such property belonging to others. We may be notified that we are infringing patents, copyright or other intellectual property rights owned by other parties. In the event of an infringement claim, we may be required to spend a significant amount of money to develop a non-infringing alternative or to obtain licenses. We may not be successful in developing alternatives or in obtaining licenses on reasonable terms, if at all. Any litigation, even without merit, could result in substantial costs and could adversely affect our business and operating results.

Our strategy has been to evaluate trade names and trademarks, and to consider seeking patents, where we believe that such trade names, trademarks or patents would be available and adequate to protect our rights to products or processes that we consider material to our business. To the extent we do seek to obtain trade names, trademarks or patents, we may be required to institute litigation in order to enforce them or other intellectual property rights to protect our business interests. Such litigation could result in substantial costs and could adversely affect sales, financial results and growth.

We are dependent on customers operating in highly competitive markets and the inability of our customers to succeed in their markets can adversely impact our business, operating results and financial condition.

The end markets we serve can experience major swings in demand which, in turn, can significantly impact our operations. Our financial performance depends on our customers' ability to compete and succeed in their markets, which, apparently has been, and could continue to be, affected directly by prevailing global economic conditions. The majority of our customers' products are characterized by rapid changes in technologies, increased standardization of technologies and shortening of product lifecycles. In many instances, our customers have experienced severe revenue erosion, pricing and margin pressures, and excess inventories during recent years.

We could suffer losses from corrupt or fraudulent business practices. Conducting business in China is inherently risky.

Corruption, extortion, bribery, pay-offs, theft, and other fraudulent practices remain common in China. For example, in fiscal 2006, we recorded a provision of approximately $1 million for doubtful sales transactions, consisting of orders primarily from three customers for products of the metallic parts division of our electronic & metallic parts business segment that had been shown as shipped to, and received by, the customers but in fact had been surreptitiously cancelled without shipment. Documentation reflecting the cancellation of the orders was uncovered following the departure of the General Manager of the Company's metallic parts division who, with the assistance of a former Production and Materials Control Supervisor in that division, had concealed such documentation. We could suffer additional losses from similar or other fraudulent practices if we are not successful in implementing and maintaining preventative measures.

Because our operations are international, we are subject to significant worldwide political, economic, legal and other uncertainties.

We are incorporated in the BVI and have subsidiaries incorporated in the BVI, Macao, Hong Kong, Samoa and China. Our administrative and accounting office is located in Macao. We manufacture all of our products in China. As of March 31, 2017, approximately 61.7% of the net book value of our total identifiable assets was located in China. We sell our products to customers principally in China, the United States, Hong Kong, Europe (the United Kingdom, Norway and Holland) and Canada. Our international operations may be subject to significant political and economic risks and legal uncertainties, including:

- changes in economic and political conditions and in governmental policies,
- changes in international and domestic customs regulations,
- wars, civil unrest, acts of terrorism and other conflicts,
- changes in tariffs, trade restrictions, trade agreements and taxation,
- difficulties in managing or overseeing foreign operations, and

- limitations on the repatriation of funds because of foreign exchange controls.

The occurrence or consequences of any of these factors may restrict our ability to operate in the affected region and negatively impact our operations in that region, or as a whole.

We depend on our executive officers, senior managers and skilled personnel.

Our success depends largely upon the continued services of our executive officers as well as upon our ability to attract and retain qualified technical, manufacturing and marketing personnel. Generally, our executive officers and senior managers are not bound by employment or non-competition agreements and we cannot assure you that we will be able retain them. The loss of service of any of our officers or key management personnel could have a material adverse effect on our business and operating results. We do not have key person insurance on our executive officers. We believe that our future success will depend, in part, on our ability to attract and retain highly skilled executive, technical and management personnel and if we are not able to do so, our business and operating results could be harmed.

Compliance with current and future environmental regulations may be costly and could impact our future operating results adversely.

The laws and regulations related to environmental protection have been tightening in recent years, requiring production facilities that may cause pollution or produce other toxic materials to take steps to protect the environment and establish an environmental protection and management system. When an entity fails to adopt preventative measures or control facilities that meet the requirements of environmental protection standards, it is subject to suspension of production or operations and for payment of fines. Compliance with relevant laws and regulations can be costly and disrupt operations.

Our operations create some environmentally sensitive waste that may increase in the future depending on the nature of our manufacturing operations. The general issue of the disposal of hazardous waste has received increasing attention from Chinese national and local governments and foreign governments and agencies and has been subject to increasing regulation. Currently, relevant Chinese environmental protection laws and regulations impose fines on discharge of waste materials and empower certain environmental authorities to close any facility which causes serious environmental problems. Although it has not been alleged that we have violated any current environmental regulations by China government officials, the Chinese government could amend its current environmental protection laws and regulations. Our business and operating results could be materially and adversely affected if we were to increase expenditures to comply with environmental regulations affecting our operations.

In addition, we could face significant costs and liabilities in connection with product take-back legislation, which enables customers to return a product at the end of its useful life and charge us with financial and other responsibility for environmentally safe collection, recycling, treatment and disposal. We also face increasing complexity in our product design and procurement operations as we adjust to new and upcoming requirements relating to the materials composition of our electronic products, including the restrictions on lead and certain other substances in electronics that apply to specified electronics products put on the market in the European Union as of July 1, 2006 (Restriction of Hazardous Substances in Electrical and Electronic Equipment Directive (RoHS)). The labeling provisions of similar legislation in China went into effect on March 1, 2007. Consequently, many suppliers of products sold into the EU countries have required their suppliers to be compliant with the new directive. Many of these customers in our electronic division have adopted this approach and have required our full compliance. Though we have devoted a significant amount of resources and effort planning and executing our RoHS program, it is possible that some of our products might be incompatible with such regulations. In such event, we could experience the loss of revenue, damages to our reputation, diversion of resources, monetary penalties, and legal action. Other environmental regulations may require us to reengineer our products to utilize components that are more environmentally compatible. Such reengineering and component substitution may result in additional costs to us. Although we currently do not anticipate any material adverse effects based on the nature of our operations and the effect of such laws, there is no assurance that such existing laws or future laws will not have a material adverse effect on us.

Power shortages in China could affect our business.

We consume substantial amounts of electricity in our manufacturing processes at our production facilities in China.

In the past, we have experienced a number of power shortages at our production facilities in China, though we are sometimes given advance notice of such power shortages. In relation to these power shortages we have a backup power system. However, there can be no assurance that in the future our backup power system will be completely effective in the event of a power shortage, particularly if that power shortage is over a sustained period of time and/or we are not given advance notice of it. Any power shortage, brownout or blackout for a significant period of time may disrupt our manufacturing, and as a result, may have an adverse impact on our business.

In the future, we may be required to write down long-lived assets and these impairment charges would adversely affect our future operating results.

As of March 31, 2017, our balance sheet included approximately $32.0 million in long-lived assets. Under applicable accounting rules, we review long-lived assets, such as property, plant, and equipment, for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Valuation of our long-lived assets requires us to make various assumptions and these assumptions are used to forecast future, undiscounted cash flows. Given the significant uncertainty and instability of macroeconomic conditions on our business in recent periods, forecasting future business remains difficult and subject to modification. If actual market conditions differ or our forecasts change, we may be required to reassess long-lived assets and could record an impairment charge. For example, because of the impact during fiscal 2011 on our injection molded plastics business of the world-wide economic slowdown prevailing in that period, we recorded non-cash impairment charges to property, plant and equipment used in that segment of $4.5 million, more than doubling the total operating loss we would have otherwise reported for the year ended March 31, 2011. We recorded an impairment charge of $197,000 on property, plant and equipment used in our plastic manufacturing operations for the year ended March 31, 2013 and $490,000 for the year ended March 31, 2014. There were no such impairment charges taken for fiscal 2015, 2016, or 2017. If we are required to take substantial impairment charges in future periods, our earnings would be decreased or our losses would be increased in the period or periods in which the charges occur.

A material failure of internal control over financial reporting could materially impact the Company’s financial results.

In designing and evaluating its internal control over financial reporting, management recognizes that any internal control or procedure, no matter how well designed and operated, can provide only reasonable assurance of achieving desired control objectives, and management is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Management believes that the Company’s internal control over financial reporting currently provides reasonable assurance of achieving their control objectives. However, no system of internal controls can be designed to provide absolute assurance of effectiveness. See Item 15 “Controls and Procedures” later in this Report. A material failure of internal control over financial reporting could materially impact the Company’s reported financial results and the market price of its stock could significantly decline. Additionally, adverse publicity related to a material failure of internal control over financial reporting could have a negative effect on the Company’s reputation and business.

Our auditor, like other independent registered public accounting firms operating in China, is not permitted to be subject to inspection by the Public Company Accounting Oversight Board, and as such, investors may be deprived of the benefits of such inspection.

Our independent registered public accounting firm that issues the audit reports included in our annual reports filed with the SEC, as an auditor of companies that are traded publicly in the United States and a firm registered with the Public Company Accounting Oversight Board (United States), or PCAOB, is required by the laws of the United States to undergo regular inspections by PCAOB to assess its compliance with the laws of the United States and professional standards. Because our auditor is located in China, a jurisdiction where PCAOB is currently unable to conduct inspections without the approval of the PRC authorities, our auditor, like other independent registered public accounting firms operating in China, is currently not inspected by PCAOB.

Inspections of other firms that PCAOB has conducted outside of China have identified deficiencies in those firms' audit procedures and quality control procedures, which may be addressed as part of the inspection process to improve future audit quality.

The inability of PCAOB to conduct inspections of independent registered public accounting firms operating in China makes it more difficult to evaluate the effectiveness of our auditor's audit procedures or quality control procedures. As a result, investors may be deprived of the benefits of PCAOB inspections.

Potential new accounting pronouncements are likely to impact our future financial position and results of operations and in the case of FASB's pronouncement regarding the expensing of stock options have adversely impacted, and will in the future, adversely impact our financial results.

We prepare our financial statements in conformity with the generally accepted accounting principles of the United States of America "U.S. GAAP." A change in these accounting principles and policies, especially as interpreted by the Securities and Exchange Commission and The NASDAQ Stock Market, may have an impact on our future financial position and results of operations. Historically, regulatory changes, such as the requirement of the Financial Accounting Standards Board to expense stock options grants, and other legislative initiatives have increased our general and administrative costs and future changes could have a similar adverse impact on our financial results.

The concentration of share ownership in our senior management allows them to control or substantially influence the outcome of matters requiring shareholder approval.

On June 30, 2017, members of our senior management and Board of Directors as a group beneficially owned approximately 51.5% of our outstanding common shares. As a result, acting together, they are able to control the outcome of all matters requiring approval by our shareholders, including the election of directors and approval of significant corporate transactions.This ability may have the effect of delaying or preventing a change in control of Deswell, or causing a change in control of Deswell that may not be favored by our other shareholders. There are no agreements, understandings, or commitments among the members of our senior management and Board of Directors to vote their shares in any specific manner, or to vote collectively for or against any matter that may come before the shareholders.

Our board's ability to amend our charter without shareholder approval could have anti-takeover effects that could prevent a change in control.

As permitted by the law of the BVI, many provisions of our Memorandum and Articles of Association, which are the terms used in the BVI for a corporation's charter and bylaws, may be amended by our board of directors without shareholder approval provided that a majority of our independent directors do not vote against the amendment. This includes amendments to increase or reduce our authorized capital stock. Our board's ability to amend certain provisions of our charter documents without shareholder approval, including its ability to create and issue further common shares, could have the effect of delaying, deterring or preventing a change in control of Deswell, including a tender offer to purchase our common shares at a premium over the then current market price.

Our exemptions from certain of the reporting requirements under the Exchange Act limits the protections and information afforded to investors.

We are a foreign private issuer within the meaning of rules promulgated under the Securities Exchange Act of 1934, as amended (the “Exchange Act”). As a foreign private issuer, we are exempt or excluded from certain provisions applicable to United States public companies including:

- the rules under the Exchange Act requiring the filing with the Commission of quarterly reports on Form 10-Q or current reports on Form 8-K;
- the sections of the Exchange Act regulating the solicitation of proxies, consents or authorizations in respect to a security registered under the Exchange Act;
- the sections of the Exchange Act requiring insiders to file public reports of their stock ownership and trading activities and establishing insider liability for profits realized from any “short-swing” trading transaction (i.e., a purchase and sale, or sale and purchase, of the issuer’s equity securities within less than six months); and
- Regulation FD, the SEC’s rules regulating disclosure of information by publicly traded companies and other issuers and requiring that when an issuer discloses material nonpublic information to certain individuals or entities such as stock analysts, or holders of the issuer’s securities who may trade on the basis of the information, the issuer must make public disclosure of that information.

In addition, because we are a foreign private issuer, certain of the corporate governance standards of The NASDAQ Stock Market that are applied to domestic companies having securities included on The NASDAQ Stock

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Market are not applicable to us. For example, as a foreign private issuer organized under the law of the BVI, we may follow our home company practice in lieu of some of the corporate governance provisions of sections 5600 *et. seq.* of NASDAQ's Marketplace Rules. Accordingly, as the law of the BVI does not prohibit us from doing so and since our practices are in compliance with our Memorandum and Articles of Association, we follow our home company practices with respect to the following NASDAQ Market Place rules:

- *Rule 5605(b)(2)*: Our independent directors do not meet in executive session;
- *Rule 5605(d)*: Our board does not have a compensation committee and compensation of our Chief Executive Officer and other executive officers is neither determined nor recommended to the board by a majority of our independent directors. For information regarding why we do not have an independent compensation committee, see the discussion under "Other Committees; NASDAQ Compliance" in Item 6 "Directors and Senior Management" of this Report
- *Rule 5605(e)*: Nominees for appointment as our directors are not selected or recommended by either a majority of our independent directors, or a nominating committee composed solely of independent directors.

Because of these exemptions or exclusions, investors are not afforded the same protections or information generally available to investors in public companies organized in the United States and having securities included on The NASDAQ Stock Market.

Item 4. INFORMATION ON THE COMPANY

Corporate Information

Deswell Industries, Inc. was founded in 1987 in Hong Kong and moved its manufacturing operations to China in 1990 to take advantage of lower overhead cost, competitive labor rate and tax concessions available in Shenzhen, China as compared with Hong Kong.

We were reincorporated in December 1993 as a limited liability International Business Company under the British Virgin Islands International Business Companies Act, 1984 ("the IBCA Act"). Effective on January 1, 2007, the BVI repealed the IBCA Act, and simultaneously with such repeal, we were automatically re-registered under the BVI's corporate law replacing the IBCA Act, the BVI Business Companies Act, 2004.

The Company's registered agent in the BVI is Harneys Corporate Services Limited, P.O. Box 71, Craigmuir Chambers, Road Town, Tortola, British Virgin Islands. The Company's principal administrative office is located in 10B Edificio Associacao Industrial De Macau, 32 Rua do Comandante Mata e Oliveira, Macao, and its telephone number is (853) 2832-2096 and its facsimile number is (853) 2832-3265. Our principal manufacturing facilities and operations are currently based in Dongguan, Guangdong, China.

Important Events in Deswell's Development

During the year ended March 31, 2015, the Company gradually outsourced manufacturing of the metal components used in assembly of the Company's audio products. As of March 31, 2015, all of the metallic components used in assembly of the Company's audio products were provided by third party suppliers. The operating results of the metallic parts business unit are reported as discontinued operations for all periods presented. We have historically reported the results of the metallic parts business as a separate segment. The continuing cash flows subsequent to the unit's closure were not significant. See Note 10 of Notes to the Company's Consolidated Financial Statements for the results of the discontinued operations of the metallic parts business unit.

Organizational Structure

The following diagram illustrates the organizational structure of the Company and its active subsidiaries at March 31, 2017.

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Capital Expenditures

Principal capital expenditures and divestitures made by Deswell during the three year periods ended March 31, 2015, 2016 and 2017 included the following (dollar amounts in thousands):

	Year ended March 31,					
	2015		2016		2017	
Purchase of property, plant and equipment	$	890	$	591	$	2,152
Proceeds from the sale of property, plant and equipment, net of transaction costs.	$	976	$	1,266	$	993

Our major capital expenditures in fiscal 2017 included:

- $1,309,000 for plant and machinery for plastic and electronic products;
- $718,000 for leasehold improvements;
- $45,000 for motor vehicles; and
- $80,000 for furniture, fixtures and equipment.

Our major capital expenditures in fiscal 2016 included:

- $295,000 for plant and machinery for plastic and electronic products;
- $114,000 for leasehold improvements;
- $73,000 for motor vehicles; and
- $109,000 for furniture, fixtures and equipment.

Our major capital expenditures in fiscal 2015 included:

- $320,000 for plant and machinery for plastic and electronic products;
- $140,000 for leasehold improvements;
- $320,000 for motor vehicles; and
- $110,000 for furniture, fixtures and equipment.

All of the foregoing capital expenditures were financed principally from internally generated funds and our current plan is to continue to use internally generated funds principally to finance future capital expenditures.

The Company has constructed its own manufacturing plant and dormitory buildings in Houjie, Dongguan China with an aggregate of approximately 1.3 million square feet of land acquired from the local government in January 2000. Management believes that the current plant facility has sufficiently met the Company’s existing requirements.

Business Overview

We are an independent manufacturer of injection-molded plastic parts and components, electronic products and subassemblies and metallic molds and accessory parts for original equipment manufacturers, or “OEMs” and contract manufacturers. We conduct all of our manufacturing activities at separate plastics, electronics and metallic operation factories located in the People’s Republic of China.

We produce a wide variety of plastic parts and components that are used in the manufacture of consumer and industrial products, using different plastic injection technologies, such as film injection, integrated injection and insert injection. The products include:

- plastic components of electronic entertainment products;
- cases for flashlights, telephones, paging machines, projectors and alarm clocks;
- toner cartridges and cases for photocopy and printer machines;
- parts for electrical products such as air-conditioning and ventilators;

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- parts for audio equipment;
- cases and key tops for personal organizers and remote controls;
- double injection caps and baby products ;
- parts for medical products such as apparatus for blood tests;
- laser key caps; and
- automobile components.

Electronic products manufactured by the Company include:

- sophisticated professional audio equipment including digital audio workstation, digital or analogue mixing consoles, instrument amplifiers, signal processors, firewire/USB audio interfaces, keyboard controllers and speaker enclosures;
- high end home theatre audio products, such as 7.1-channel audio-visual Hi-Fi stereo receivers-amplifiers;
- complex printed circuit board assemblies using surface mount technology (“SMT”), automatic insertion (“AI”) and pin-through-hole (“PTH”) interconnection technologies; and
- telecommunication products, such as VoIP keysets for business communications.

Historically, metal products manufactured by the Company include metallic molds and necessary parts used in audio equipment, telephones, copying machines, pay telephones, multimedia stations, automatic teller machines, vending machines, and more. As manufacturing of the metallic components is considered to be one of the production processes that may emit pollutants, during the year ended March, 31, 2015 the Company gradually outsourced manufacturing of the metal components used in assembly of the Company’s audio products. Since March, 2015, all the metallic components used in assembly of the Company’s audio products were provided by third party suppliers

As part of its manufacturing operations, the Company consults with its customers in the design of plastic parts and the design and production of the molds used to manufacture plastic parts, which are made by Deswell at its customers’ expense, and provides advice and assistance in the design and manufacturing of printed circuit boards. The Company believes that its ability to manufacture high-end plastic and metallic accessory parts of the quality required by OEMs and contract manufacturers which furnish products and services internationally, Deswell’s expertise in designing and manufacturing molds for its customers and the Company’s low production costs distinguish Deswell from most other manufacturers of plastic products and provide it with a competitive advantage. However, this advantage has been difficult to maintain as a result of increased competition and increased production overheads during the last three fiscal years.

Industry Overview

Management believes that the injection molding and parts manufacturing industries have each benefited in recent years from a trend among major users of injection molded and metal products to outsource an increasing portion of the parts requirements and to select a small number of suppliers or a sole supplier to provide those products. The Company is not aware of any empirical data defining the manufacturing industry in China, however, management believes that injection molding firms which are much smaller than the Company make up the largest segment of the industry in China. The Company’s experience indicates that such smaller firms are often unable to react quickly and responsively to the diverse demands of many customers and are not capable of furnishing the level of quality that high-end plastic and metal products require. Management believes that this inability on the part of these smaller manufacturers has created opportunities for the Company to increase sales by catering to the outsourcing requirements of OEMs and contract manufacturers that manufacture such high-end products.

Similarly, as a result of the recognition by OEMs in the electronics industry of the rising costs of operating a manufacturing site and the need to add more sophisticated and expensive manufacturing processes and equipment, OEMs have turned increasingly to outside contract manufacturers. By doing so, OEMs are able to focus on research, product conception, design and development, marketing and distribution, and to rely on the production expertise of contract manufacturers. Other benefits to OEMs of using contract manufacturing include: access to manufacturers in regions with low labor and overhead costs, reduced time to market, reduced capital investment, improved inventory management, improved purchasing power and improved product quality. In addition, the use of contract manufacturers has helped OEMs manage production in view of increasingly shorter product life cycles.

Operations

Plastic Injection Molding

Plastic injection molding manufacturing accounted for 51.9%, 44.5%, and 52.2% of the Company's total sales during the years ended March 31, 2015, 2016, and 2017, respectively. At March 31, 2017, the Company conducted its plastic manufacturing operations in approximately 1,070,000 square feet of factory space in its factory located in Dongguan, China.

The Company's plastic injection molding process consists of three phases: (1) mold design and production; (2) plastic injection; and (3) finishing.

Mold design and production

The plastic injection-molding process begins when a customer provides the Company with specifications for a product or part, which specifications are often created in consultation with the Company's technical staff. Next the Company designs and produces the mold, using great care in the design process and in the selection of materials to produce the mold in an effort to create a high quality appearance of the completed product by reducing or eliminating potential flaws such as the sinkage of materials and irregularities in the knit line of joints. The mold-making process ranges from 40 to 50 days, depending on the size and complexity of the mold. Mold making requires specialized machines and is capital intensive. At March 31, 2017, the Company used 30 EDMs (electrical discharge machines), 32 CNC (computer numerical control) milling machines and 83 NC (numerical control) milling machines in the mold-making process.

The customer generally bears the cost of producing the molds and, as is customary in the industry, the customer owns them. However, the Company maintains and stores the molds at its factory for use in production and it is Deswell's policy generally not to make molds for customers unless the customer undertakes to store its molds at the Company's factory and uses Deswell to manufacture the related parts. In that way, the Company seeks to use its mold-making expertise to create dependence on it for the customer's parts requirements. Beginning in 2005, however, through its then newly created Export Tooling Department, Deswell's began producing molds for export to customers and thus does not use those molds to manufacture related parts.

During the year ended March 31, 2017, the Company made an average of approximately 25 to 30 molds each month. The average weight of the molds produced by the Company is about 1,800 pounds costing an average of $10,000 per set. Management believes that the Company’s skills and expertise in mold-making, coupled with having its facilities and operations in China, allow the Company to produce molds at costs substantially less than molds of comparable quality made in Japan, Korea and Taiwan.

Plastic Injection

During the mold-making process, suitable plastic resin for the particular product is selected and purchased. See “Raw Materials, Component Parts and Suppliers,” below. The completed mold is mounted onto injection machines, which are classified according to the clamping force (the pressure per square inch required to hold a mold in place during the injection molding process). At March 31, 2017, the Company had approximately 200 injection molding machines, ranging from 30 to 1,600 tons of clamping force, with most machines in the range of from 86 to 380 tons. Each of the Company’s machines is capable of servicing a variety of applications and product configurations and the Company has machines which permit the Company to fabricate plastic parts as small as a button and as large as a 3 ft. x 2 ft. case for a copy machine.

Using separate shifts, injection molding can be conducted 24 hours a day, five to seven days per week, other than during normal down time for maintenance and changing of product molds. Molding of products requiring extra concerns for appearance, such as cases for calculators, personal organizers and telephones are conducted in an isolated and dust free section of the factory. In a continuous effort to assure quality, the Company’s quality control personnel inspect the products produced from each machine generally at hourly intervals during production. When defects are discovered, the Company’s maintenance personnel inspect the mold and the machine to determine which is responsible. If the mold is the cause of the defect, it will be immediately removed from the machine and serviced or repaired by one of a team of technicians employed to maintain molds. The mold will then be remounted on the machine and production will continue. If the machine is the source of the defect, the Company’s technicians and engineers service the machine immediately. Through this continuous vigilance to molds and machines, the Company has experienced what it believes to be a relatively low scrap rate and has been able to maintain a high level of productivity of its injection molding machines.

During the year ended March 31, 2015, the Company did not acquire any new nor dispose of any old injection molding machines.

During the year ended March 31, 2016, the Company disposed of 47 old plastic injection molding machines and added 4 new ones.

During the year ended March 31, 2017, the Company disposed of 12 old plastic injection molding machines and added 10 new ones.

Finishing

After injection molding, products are finished. Finishing consists of smoothing and polishing, imprinting letters, numbers and signs through silk screening process, pad printing or epoxy ultra violet cutting, and treating the product with an anti-fog coating for a lasting and attractive appearance. Most of these functions are conducted by hand.

Electronic Products and Assemblies

In an aggregate of approximately 223,000 square feet of factory space at March 31, 2017 located at facilities in Dongguan, China, the Company manufactures and assembles electronic products and electronic assemblies for OEMs. Finished products include consumer and sophisticated studio-quality audio equipment, IPBX and commercial telephone units, network education platforms, IP switches, routers etc. Assemblies consist of printed circuit boards (“PCBs”) with passive (e.g., resistors, capacitors, transformers, switches and wire) and active (e.g., semiconductors and memory chips) components mounted on them. During the years ended March 31, 2015, 2016, and 2017, manufacturing of electronic products accounted for approximately 48.1%, 55.5%, and 47.8% respectively, of the Company’s total sales.

In assembling printed circuit boards the Company purchases printed circuit boards, surface mounted components and chips and uses automatic insertion and pin-through-hole interconnection technologies to assemble various components onto the PCBs. Before delivery, completed PCBs are checked by in-circuit testers and outgoing quality assurance inspections are performed.

PTH is a method of assembling printed circuit boards in which component leads are inserted and soldered into plated holes in the board. While this technology is several decades old and is labor intensive, it still has a significant market, particularly for consumer product applications.

BGA is a method of mounting an integrated circuit or other component to a PCB. Rather than using pins that consume a large area of the PCB, the component is attached to the circuit board with small balls of solder at each contact. This method allows for greater component density and is used in more complex PCBs.

SMT is the automatic process of printed circuit board assembly in which components are mounted directly to the surface of the board, rather than being inserted into holes. With this process, solder is accurately stenciled in paste form on pads located on the printed circuit board and the components are then placed onto the solder paste and fused to the melting point of the paste to establish a strong solder joint between components and the printed circuit board. The SMT process allows miniaturization of PCBs, cost savings and shorter lead paths between components (which results in faster signal speed and improved reliability). Additionally, it allows components to be placed on both sides of the printed circuit board, a major factor for the purpose of miniaturization.

Manufacturing operations include PCB assembly, wiring and testing. The process is completed by assembling the PCBs into a plastic or metal housing that comprises the finished product. Quality assurance is then conducted in accordance with the customers' requirements before the shipment.

Metal Parts Manufacturing

During the fourth quarter of 2015, the Company closed down its metallic parts business unit and sold all of its assets. The operating results of the metallic parts business unit are reported as discontinued operations for all periods presented. We have historically reported the results of the metallic parts business as a separate segment. The continuing cash flows subsequent to the unit's closure were not significant. See Note 10 of Notes to the Company's Consolidated Financial Statements for the results of the discontinued operations of the metallic parts business unit.

Quality Control

The Company maintains strict quality control procedures for its products. At hourly intervals, the Company's quality control personnel monitor machines and molds to assure that plastic parts are free from defects.

For electronic operations, the Company's quality control personnel check all incoming components. Moreover, during the production stage, the Company's quality control personnel check all work in process at several points in the production process. Finally, after the final assembly and before shipment, the Company conducts quality assurance inspections in accordance with the customers' Acceptable Quality Level, or AQL, requirements.

In 1995, the Company earned ISO 9001 certifications for both its plastic and electronic products manufacturing operations. The "ISO" or International Organization for Standardization is a Geneva-based organization dedicated to the development of worldwide standards for quality management guidelines and quality assurance. ISO 9000, which is the first quality system standard to gain worldwide recognition, requires a company to gather, analyze, document and monitor and to make improvements where needed. ISO 9001 is the ISO level appropriate for manufacturers like the Company. The Company's receipt of ISO 9001 certification demonstrates that the Company's manufacturing operations meet the established world standards.

In August 2004, the Company's plastic injection manufacturing plant in Dongguan also obtained ISO 14001 certification, which evidences that the Company's environmental management standards meet established international standards. ISO 14000 is a series of international standards on environmental management. ISO 14001 is the most well-known of these standards and is often seen as the cornerstone standard of the ISO 14000 series. In January 2006, the Company's electronic manufacturing plant also obtained ISO 14001 certification.

In July 2006, Deswell obtained ISO/TS 16949 Certification for plastic injection manufacturing plant.ISO/TS 16949 is an ISO Technical Specification aligning existing American (QS-9000), German (VDA6.1), French (EAQF) and Italian (AVSQ) automotive quality systems standards within the global automotive industry. Together with ISO 9001:2008, ISO/TS 16949 specifies the quality system requirements for the design/development, production, installation and servicing of automotive related products. ISO/TS 16949 has been accepted as an equivalent to QS-9000, VDA6.1, AVSQ, and EAQF. ISO/TS 16949 does not replace QS-9000; but is optional and eliminates the need for multiple certifications.

Raw Materials, Component Parts and Suppliers

Plastic Resins

The primary raw materials used by the Company in the manufacture of its plastic parts are various plastic resins, primarily ABS (acrylonitrile-butadiene-styrene). The chart shows Deswell's average cost of ABS as a percentage of the total cost of plastic products sold and as a percentage of total cost of goods sold during its last three fiscal years.

Because plastic resins are commodity products, the Company has no long-term supply agreements for plastic resins. The Company selects its suppliers based on price, lead time, the brand name or those that are appointed by its customers. Most of its plastic resins are obtained from suppliers in Mainland China and Hong

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Kong. Deswell normally maintains a two to three month inventory supply.

The Company used in excess of 7,640,000 pounds of plastic resins during the year ended March 31, 2017. Management believes that the Company's large volume purchases of plastic resin have generally resulted in lower unit raw material costs and generally have enabled the Company to obtain adequate shipments of raw materials. While the Company is not generally bound by fixed price contracts with its customers, the Company has found that increases in resin prices can be difficult to pass on to its customers and, as a consequence, a significant increase in resin prices could have, and in the past has had, a material adverse effect on the Company's operations.

The primary plastic resins used by the Company are produced from petrochemical intermediates derived from products of the natural gas and crude oil refining processes. Natural gas and crude oil markets have in the past experienced substantially cyclical price fluctuations as well as other market disturbances including shortages of supply and crises in the oil producing regions of the world. The capacity, supply and demand for plastic resins and the petrochemical intermediates from which they are produced are also subject to cyclical and other market factors. Consequently, plastic resin prices may fluctuate as a result of natural gas and crude oil prices and the capacity, supply and demand for resin and petrochemical intermediates from which they are produced. Over the past several years, oil prices have experienced significant volatility and remain extremely uncertain. Sustained increases in oil prices could result in higher costs for plastic resins.

Although the plastics industry has from time to time experienced shortages of plastic resins, the Company has not experienced to date any such shortages. Management believes that there are adequate sources available to meet the Company's raw material needs.

Component Parts and Supplies for Electrical Products Manufacturing

The Company purchases a wide variety of component parts from numerous suppliers and is not dependent upon any single supplier for any essential component. The Company purchases from suppliers in China, Hong Kong, Taiwan, Singapore, the United Kingdom and the United States. At various times there have been shortages of parts in the electronics industry, and certain components, including integrated circuits, diodes, transistors and other semiconductors, have been subject to allocations by their suppliers, particularly if they are complex and/or customized for a particular use. Although shortages of parts and allocations have not had a material adverse effect on the Company's results of operations, there can be no assurance that any future shortages or allocations would not have such an effect.

For a discussion of various risks we face associated with obtaining needed components used in our manufacture of electronic products, please see "Shortages of components and materials used in our production of electronics products may delay or reduce our sales and increase our costs” and “We face inventory risks of obsolescence and impairment charges by providing turnkey manufacturing of electronic products” beginning on page 12 of the Risk Factor section of this Report.

Transportation

Transportation of components and finished products to customers in Shenzhen and to and from Hong Kong and Shenzhen and Dongguan is by truck. Generally, the Company sells its products F.O.B. China or F.O.B. Hong Kong. To date, the Company has not been materially affected by any transportation problems and has found that the transition of Hong Kong to Chinese control in July 1997 has not had an adverse impact on the Company’s ability to transport goods to and from Hong Kong and China.

Customers and Marketing

The Company’s customers are OEMs and contract manufacturers. The Company sells its products principally in China, the United States, Hong Kong and Europe (the United Kingdom, Norway and Holland) and Canada. Net sales to customers by geographic area are determined by reference to shipping destinations as directed by the Company’s customers. For example, if the products are delivered to the customer in Hong Kong, the sales are recorded as generated in Hong Kong; if the customer directs the Company to ship its products to Europe, the sales are recorded as sold to Europe. See Note 20 of Notes to Consolidated Financial Statements for the dollar amounts of export sales by geographic area for each of the years ended March 31, 2015, 2016 and 2017. Net sales as a percentage of total sales to customers by geographic area consisted of the following for the years ended March 31, 2015, 2016 and 2017:

	Year ended March 31,		
Geographical Area	**2015**	**2016**	**2017**
China	42.3 %	42.1 %	46.4 %
United States	26.0	18.2	20.0
Europe	9.2	14.4	10.7
Hong Kong	14.5	17.2	13.0
United Kingdom	2.7	2.3	3.4
Others	5.3	5.8	6.5
Total	100.0%	100.0%	100.0%

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We believe that our reported sales by geographic area do not necessarily reflect the final destinations of our products or the actual nationalities of our customers. For example, we have reported product sales in China amounting to 46.4% of our total net sales for the year ended March 31, 2017 because China is where our customers directed us to deliver the products. However, we believe that these sales were to offshore customers using local China shipping destinations, which in turn, transshipped our products offshore.

The Company markets its products and services to existing customers through direct contact with the Company's management and direct sales personnel. The Company's sales personnel attend trade shows, exhibitions and conventions. Collecting information from trade shows, as well as websites, Deswell's marketing staff contacts existing and potential customers directly by telephone, mail, fax, e-mail via the Internet and in person, stressing Deswell's capability as a complete solution provider for plastic injection mold design, tooling and molding as well as an electronics manufacturing services, or EMS, provider of advanced technology manufacturing processes and flexible logistic services.

The Company's sales transactions with all of its customers are based on purchase orders received by the Company from time to time. Except for these purchase orders, the Company has no written agreements with its customers. Sales of plastic parts, electronic products and metallic products are primarily made on credit terms, with payment in United States dollars or Hong Kong dollars expected within 30 to 90 days of shipment. In certain cases, primarily new customers of electronic products, sales are supported by letters of credit and are payable in United States dollars. To date, the Company has not experienced any significant difficulty in collecting accounts receivable on credit sales. Management communicates regularly with credit sale customers and closely monitors the status of payment and in this way believes it has kept the default rate low. Additionally, plastic parts deliveries are made in several installments over a lengthy period of time, which permits the Company to withhold delivery in the event of any delinquency in payment for past shipments. While the Company has not experienced any material difficulty in being paid by its customers, there can be no assurance that the Company's favorable collection experience will continue.

Customers

The Company's success depends to a significant extent on the success achieved by its customers in developing and marketing their products, some of which may be new. Many of the industry segments served by the Company's customers are subject to technological change, which can result in short product life cycles. The Company could be materially adversely affected if advances in technology or other factors reduce the marketability of essential products of its customers or if new products being developed by its customers do not attain desired levels of acceptance.

Historically, the Company has depended, currently depends, and expects to continue to depend, on a small number of customers for a significant percentage of its net sales. The following table sets forth Deswell's major customers which accounted for 10% or more of its net sales during fiscal 2015, 2016 and 2017:

	Year ended March 31,		
	2015	2016	2017
Customer A	16.5%	12.7%	12.8%
Customer B	*	13.6%	10.6%
Customer C	13.7%	10.4%	10.2%

*Less than 10% in the year indicated.

If the Company's major customers experience a decline in the demand for their products as a result of the prevailing economic environment or other factors, the products or services that we provide to them could be reduced or even terminated. The loss of any of our major customers or a substantial reduction in orders from any of them would adversely impact our sales and operating results unless and until we were able to replace the customer or order with one or more of comparable size.

The Company's sales are based on purchase orders and there are no long-term contracts with any of

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Deswell's customers. The percentage of sales to the Company's customers has fluctuated in the past and may fluctuate in future. Substantial decreases in sales to, or the loss of major customers, have adversely impacted Deswell's sales and financial performance.

Present or future customers could cease to use Deswell as the source of the injection-molded plastic parts and components it manufactures for electronic manufacturing services of electrical products and subassemblies or for metallic molds and accessories or significantly change, reduce or delay the amount of products and services ordered. The Company's sales will continue to decline and its financial results will suffer further if orders from its largest customers, or orders from other substantial customers, cease or are significantly reduced unless Deswell can increase sales from other existing customers or add sales from new customers.

Competition

We compete with a number of different companies in production of injection-molded plastic parts and components, electrical products and subassemblies and metallic molds and accessories. For example, we compete with major global EMS providers, other smaller EMS companies that have a regional or product-specific focus, and original design manufacturers with respect to some of the services that we provide. We also compete with our current and prospective customers, who can manufacture internally and who evaluate our capabilities in light of their own capabilities and cost structures. Our market segments are extremely competitive, many of our competitors have achieved substantial market share and many have lower cost structures and greater manufacturing, financial or other resources than we do. We face particular competition from Asian-based competitors, including Taiwanese EMS providers who compete in our end markets.

The Company believes that competition for plastic injection molding, contract electronic manufacturing and parts manufacturing businesses are based on price, quality, service and the ability to deliver products in a timely and reliable basis.

Patents, Licenses and Trademarks

The Company has no patents, trademarks, licenses, franchises, concessions or royalty agreements that are material to its business.

Seasonality

For information concerning the seasonality of the Company's business, see "Seasonality" included under Item 5 "Operating and Financial Review and Prospects."

Property, Plants and Equipment

Macao

The Company leases Units 10B and 10C Edificio Associacao Industrial De Macau, No. 32-36 Rua do Comandante Mata e Oliveira, Macao from an unaffiliated party, each being for a term of two years to May 2018. The premises are used as trading, administrative and accounting offices for the Company's plastic injection business and electronic & metallic business, respectively. The monthly rent is approximately $3,600.

Southern China

In January 2000, the Company acquired under a land-lease agreement with the local government an aggregate of approximately 1.3 million square feet of land to construct its own manufacturing plant and dormitory buildings in Houjie, Dongguan, China. Under the land-lease agreement, the Company has the right to use the land for 50 years. On this land, Deswell has through March 31, 2017 constructed approximately

- 1,070,000 square feet of factory space,
- 91,000 square feet of amenity space,
- 133,000 square feet of office building space, and
- 470,000 square feet of dormitory space.

Deswell now uses this facility for its plastic manufacturing operations.

Manufacturing facilities and warehouses identified to be idle during the year were leased to third parties for rental income. Rental income of $600,000, $793,000 and $839,000 was earned during the years ended March 31, 2015, 2016, and 2017, respectively.

See Note 7 of Notes to the Company's Consolidated Financial Statements for Assets Held For Sale.

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In July 2003, the Company acquired under a land-lease agreement with a third party an aggregate of approximately 244,000 square feet of land and approximately 420,000 square feet of buildings, including six blocks of dormitory buildings, a canteen, a factory building, a car park and a guard room, at Chang An, Dongguan, China, which was previously named Kwan Hong Building. The land use period is for 50 years from February 1, 2003 to January 31, 2053. The Company uses the facilities for its electronic products manufacturing operations.

The Company believes that its existing offices and manufacturing space, and manufacturing space in close proximity to its existing facilities, which management believes will be available as needed for limited expansion, will be adequate for the operation of its business for at least the next two years.

Material Effects of Government Regulations

See discussion of increasing minimum wage levels in Guangdong Province and corresponding increases in employer contributions for mandatory social welfare benefits for Chinese employees on page 7.

Item 4A. UNRESOLVED STAFF COMMENTS

Not applicable to Deswell.

Item 5. OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Except for statements of historical facts, this section contains forward-looking statements involving risks and uncertainties. You can identify these statements by forward looking words including "expect," "anticipate," "believe," "seek," and "estimate." Forward looking statements are not guarantees of Deswell's future performance or results and the Company's actual results could differ materially from those anticipated in these forward-looking statements as a result of certain factors, including those set forth under the section of this Report entitled Item*3 "Key Information – Risk Factors."*

Operating Results

The following discussion should also be read in conjunction with the consolidated financial statements and notes thereto included following Item 18 of this Report. The Company prepares its financial statements in accordance with U.S. GAAP.

General

The Company's revenues are derived from the manufacture and sale of injection-molded plastic parts and components, electrical products and subassemblies and metallic molds and accessories.

The manufacturing of the metallic components is considered to be one of the production processes which may emit pollutants. During the year ended March 31, 2015, the Company gradually outsourced manufacturing of the metal components used in assembly of the Company's audio products. As of March 31, 2015, all of the metallic components used in assembly of the Company's audio products were provided by third party suppliers. The operating results of the metallic parts business unit are reported as discontinued operations for all periods presented. We have historically reported the results of the metallic parts business as a separate segment. The continuing cash flows subsequent to the unit's closure were not significant. See Note 10 of Notes to the Company's Consolidated Financial Statements for the results of the discontinued operations of the metallic parts business unit.

The Company carries out all of its manufacturing operations in Southern China, where it has been able to take advantage of the lower overhead costs and labor rates as compared to Hong Kong. At the same time, the proximity of the Company's factories in Southern China to Hong Kong permits the Company to easily manage its manufacturing operations from Macao, facilitates transportation of its products through Hong Kong.

PRC Income Taxes

From January 1, 2008, with the effect of the new PRC Income Tax Law, the standard income tax rate for all subsidiaries operating in the PRC has been reduced from the rate of 33% to 25%.

Accordingly, with the enactment of new PRC Enterprise Tax effective January 1, 2008, the benefits the Company previously enjoyed, such as receiving tax refunds as a result of its reinvestment of profits in certain of its subsidiaries in China and favorable concession rates, are no longer available.

The Company is subject to the applicable transfer pricing rules in PRC in connection to the transactions between its subsidiaries located inside and outside PRC. In accordance to Guo Shui Fa [2009] No.2 "Implementation Regulations of Special Tax Adjustments (Provisional)"("Guo Shui Fa [2009] No.2"), which took effect at

the beginning of calendar year 2008 and set out the regulations in relation to transfer pricing, contemporaneous documentation, disclosure and compliance of intercompany transactions, the Company and external consultantshave prepared transfer pricing contemporaneous documentations (the “Contemporaneous Documentations”) of its subsidiaries in PRC for every calendar year.

The amount of current tax liability at March 31, 2017 includes the deemed profit tax estimated by the management based on the Contemporaneous Documentations.

Business Segment Information

Deswell’s operations are generally organized in three segments: plastic injection molding, which we sometimes refer to as the “plastics segment,” electronic products assembling and metallic parts manufacturing (which has since been discontinued as discussed above). The Company’s reportable segments are strategic business units that offer different products and services. See Note 20 of Notes to Consolidated Financial Statements. The following table sets forth selected consolidated financial information presented as a percentage of net sales by segment for each of the three years in the period ended March 31, 2017:

	Year ended March 31, 2015			**Year ended March 31, 2016**			**Year ended March 31, 2017**		
	Plastic Injection Molding Segment	**Electronic Segment**	**Total from Continuing operations**	**Plastic Injection Molding Segment**	**Electronic Segment**	**Total from Continuing operations**	**Plastic Injection Molding Segment**	**Electronic Segment**	**Total from Continuing operations**
Net sales	100.0%	100.0 %	100.0 %	100.0%	100.0 %	100.0 %	100.0%	100.0 %	100.0 %
Cost of sales	83.1	95.1	88.9	82.9	94.3	89.2	78.6	88.4	83.3
Gross profit	16.9	4.9	11.1	17.1	5.7	10.8	21.4	11.6	16.7
Selling, general and administrative expenses	29.3	18.2	24.0	26.8	15.4	20.5	25.2	14.1	19.9
Other income, (expenses), net	—	0.5	0.2	(6.6)	1.2	(2.3)	(4.3)	1.5	(1.6)
Operating loss	(12.4)	(12.8)	(12.7)	(16.3)	(8.5)	(12.0)	(8.1)	(1.0)	(4.8)
Non-operating income, net	10.7	2.4	6.7	2.8	—	1.3	11.8	4.5	8.3
Loss before income taxes	(1.7)	(10.4)	(6.0)	(13.5)	(8.5)	(10.7)	3.7	3.5	3.5
Income taxes	0.8	0.2	0.5	0.5	0.2	0.4	0.7	0.3	0.5
Net loss	(2.5)%	(10.6)%	(6.5)%	(14.0)%	(8.7)%	(11.1)%	3.0 %	3.2 %	3.0 %

Year ended March 31, 2017 (Fiscal 2017) Compared to Year Ended March 31, 2016 (Fiscal 2016)

Net Sales – The Company's net sales from continuing operations for the year ended March 31, 2017 were $44,522,000, a decrease of $46,000 or 0.1% as compared to $44,568,000 in fiscal 2016. The slight decrease was related to a decrease in sales revenues of $3,465,000 in our electronic segment, offsetting an increase of $3,419,000 in our plastic segment, as compared with the respective net sales from these segments in the prior fiscal year.

The revenue increase in the plastic segment was due to an increase of $5,041,000 in orders from existing customers for printing, office equipment, and local sales, offsetting a decrease of $2,010,000 in sales orders from existing customers, mainly for tooling and audio products.

The revenue decrease in the electronic segment was mainly due to a decrease of $5,636,000 in orders from existing customers for professional audio instruments, offsetting an increase of $2,119,000 in orders for professional audio equipment from other existing customers.

Gross Profit – Gross profit for the year ended March 31, 2017 was $7,449,000, representing a gross profit margin of 16.7%. This compared with the overall gross profit of $4,793,000 and gross profit margin of 10.8% for the year ended March 31, 2016.

Gross profit in the plastic segment increased by $1,598,000 to $4,979,000 or 21.4% of net sales for the year ended March 31, 2017, as compared to $3,381,000 or 17.1% of net sales for the prior fiscal year. The increase in gross margin for the plastic segment was mainly due to a decrease in labor cost, as a percentage of net sales, when compared with the prior fiscal year.

Gross profit in the electronic segment increased by $1,058,000 to $2,470,000 or 11.6% of net sales for the year ended March 31, 2017, as compared to $1,412,000 or 5.7% of net sales for the prior fiscal year. Gross margin was twice that of fiscal year 2016, and mainly attributable to decreases in labor cost and raw materials cost, as a percentage of sales, when compared with the prior fiscal year.

Selling, General and Administrative Expenses – SG&A expenses for the year ended March 31, 2017 were $8,856,000 or 19.9% of total net sales, as compared to $9,119,000 or 20.5% of total net sales for the year ended March 31, 2016. SG&A expenses decreased by $263,000 or 2.9% in fiscal year 2017 compared to the prior fiscal year.

SG&A in the plastic segment increased by $559,000 to $5,866,000 or 25.2% of net sales for the year ended March 31, 2017, compared to $5,307,000 or 26.8% of net sales for fiscal year 2016. The increase was primarily related to an increase in $482,000 in staff costs and $133,000 in selling expense, as compared with the prior fiscal year.

SG&A expenses in the electronic segment decreased by $822,000 to $2,990,000 or 14.1% of net sales for the year ended March 31, 2017, compared to $3,812,000 or 15.4% of net sales for fiscal year 2016. The decrease was mainly due to decreases of $606,000 in staff costs and of $167,000 in selling expense, when compared to the prior fiscal year.

Other Income/Expense, Net – Other expense was $696,000 for the year ended March 31, 2017, as compared to other expense of $1,021,000 in the prior fiscal year.

On a segment basis, other expense attributable to the plastic segment for the year ended March 31, 2017 was $1,006,000, as compared to other expense of $1,310,000 for the prior fiscal year. Other expense in fiscal year 2017 was mainly due to $412,000 in exchange loss, $198,000 of loss on disposal of fixed assets and a provision of $398,000 for doubtful receivables, as compared to disposal of fixed assets of $426,000, an exchange loss of $600,000, and a provision of $273,000 for doubtful receivables during fiscal year 2016.

Other income attributable to the electronic segment was $310,000 for the year ended March 31, 2017, as compared with other income of $289,000 for the prior fiscal year. The increase in other income was mainly due to an increase of $36,000 in gain on the disposal of fixed assets and $47,000 in other income offsetting an increase of $69,000 in loss on the sale of materials during the year ended March 31, 2017 as compared to the prior fiscal year.

Operating Loss – Operating loss was $2,103,000 for the year ended March 31, 2017, as compared to operating loss of $5,347,000 in the prior fiscal year.

On a segment basis, the operating loss in the plastic segment was $1,893,000 in the year ended March 31, 2017, as compared to an operating loss of $3,236,000 in fiscal year 2016. The decrease in operating loss in the plastic segment was mainly due to an increase in gross margin as well as a decrease in other expense as a percentage of net sales.

The electronic segment reported an operating loss of $210,000 in the year ended March 31, 2017, compared to an operating loss of $2,111,000 in fiscal year 2016. The significant decrease in operating loss was largely due to the significant increase in gross margin as described above.

Non-Operating Income – Non-operating income for the year ended March 31, 2017 was $3,688,000, as compared to non-operating income of $571,000 in the prior fiscal year. The increase was primarily due to unrealized gain from marketable securities of $1,999,000 in fiscal 2017 as compared to unrealized loss from marketable securities of $1,860,000 in fiscal year 2016.

Income Taxes – Income tax for the year ended March 31, 2017 represented an income tax expense of $116,000 and a deferred tax provision of $93,000, as compared to an income tax expense of $103,000 and a deferred tax provision of $55,000 in the prior fiscal year.

On a segment basis, there was income tax expense of $61,000 and a deferred tax provision of $93,000 in the plastic segment for the year ended March 31, 2017, as compared to income tax expense of $50,000 and a deferred tax provision of $54,000 for the prior fiscal year. The income tax of the electronic segment was $55,000 for the year ended March 31, 2017, as compared to $54,000 in fiscal year 2016.

Net Income- The Company had net income of $1,376,000 for the year ended March 31, 2017, as compared to a net loss of $4,934,000 for the year ended March 31, 2016. The increase in net income was mainly the result of increases in gross margin and non-operating income as described above.

Net income for the plastic segment for the year ended March 31, 2017 was $689,000, as compared to a net loss of $2,776,000 for fiscal year 2016. The increase in net income in the plastic segment was mainly due to an increase in non-operating income as described above.

Net income for the electronic segment was $687,000 for the year ended March 31, 2017, compared to a net loss of $2,158,000 in fiscal year 2016. The increase in net income in the electronic segment was mainly attributable to increases in gross margin and non-operating income as described above.

Year ended March 31, 2016 (Fiscal 2016) Compared to Year Ended March 31, 2015 (Fiscal 2015)

Net Sales – The Company's net sales from continuing operations for the year ended March 31, 2016 were $44,568,000, an increase of $6,492,000 or 17.1% as compared to $38,076,000 in fiscal 2015. The increase was related to an increase in sales revenues of $53,000 in our plastic segment and an increase of $6,439,000 in our electronic segment, as compared with the respective net sales from these segments in the prior fiscal year.

The revenue increase in the plastic segment was due to an increase of $2,894,000 in orders from existing customers for printing, office equipment and local sales, offsetting a decrease of $2,841,000 in sales orders from existing customers mainly for telephone, medical and other products.

The revenue increase in the electronic segment was mainly due to an increase of $8,858,000 in orders from existing customers for home entertainment products and professional audio instruments, offsetting a decrease of $2,535,000 in orders for professional audio equipment from other existing customers. The increase in sales orders was mainly attributed to the continued efforts to develop new opportunities and collaborating new products with our existing customers.

Gross Profit – Gross profit from continuing operations for the year ended March 31, 2016 was $4,793,000, representing a gross profit margin of 10.8%. This compared with the overall gross profit from continuing operations of $4,224,000 and gross profit margin of 11.1% for the year ended March 31, 2015.

Gross profit in the plastic segment increased by $46,000 to $3,381,000 or 17.1% of net sales for the year ended March 31, 2016, as compared to $3,335,000 or 16.9% of net sales, for the same period in the prior fiscal year. The increase in gross margin for the plastic segment was mainly due to a decrease in factory overheads, as a percentage of net sales, when compared with the prior fiscal year.

Gross profit in the electronic segment increased by $523,000 to $1,412,000 or 5.7% of net sales for the year ended March 31, 2016, as compared to $889,000 or 4.9% of net sales, for the prior fiscal year. The increase in gross margin was mainly attributed to decreases in labor cost and factory overheads, offsetting an increase in raw materials cost, as a percentage of sales, when compared with the prior fiscal year.

Selling, general and administrative expenses – SG&A expenses from continuing operations for the year ended March 31, 2016 were $9,119,000 or 20.5% of total net sales from continuing operations, as compared to $9,123,000 or 24.0% of total net sales from continuing operations for the year ended March 31, 2015. Selling, general and administrative expenses decreased by $4,000 in fiscal 2016 compared to fiscal 2015.

SG&A expenses in the plastic segment decreased by $493,000 to $5,307,000 or 26.8% of net sales for the year ended March 31, 2016, compared to $5,800,000 or 29.3% of net sales for fiscal 2015. The decrease was primarily related to decreases of $139,000 in stock compensation cost, $41,000 in legal and professional fees, $64,000 in local government taxes, $28,000 in traveling expense, as well as $124,000 in selling expense, as compared with the same period in the prior fiscal year.

SG&A expenses in the electronic segment increased by $489,000 to $3,812,000 or 15.4% of net sales for the year ended March 31, 2016, compared to $3,323,000 or 18.2% of net sales for fiscal 2015. The increase was mainly due to increases of $600,000 in staff costs, offsetting decreases of $60,000 in stock compensation cost, $49,000 in local government taxes and $15,000 in utility expense, as well as $29,000 in selling expense, when compared to prior fiscal year.

Other income/expense, net – Other expense from continuing operations was $1,021,000 for the year ended March 31, 2016, as compared to other income from continuing operations of $93,000 in prior fiscal year.

On a segment basis, other expense attributable to the plastic segment for the year ended March 31, 2016 was $1,310,000, as compared to other income of $9,000 for prior fiscal year. Other expense in fiscal 2016 was mainly due to $600,000 in exchange loss, $426,000 of loss on the disposal of fixed assets and a provision of $273,000 for doubtful receivables, as compared to gains on the disposal of fixed assets of $259,000 and of $20,000 for materials, offsetting an exchange loss of $170,000 and a provision of $98,000 for doubtful receivables during fiscal 2015.

Other income attributable to the electronic segment for the year ended March 31, 2016 was $289,000, as compared with other income of $84,000 for the prior fiscal year. This decrease in other income was mainly due to gains of $49,000 from exchange, of $153,000 from sale of materials and others, and of $83,000 in other income during the year ended March 31, 2016, as compared to a gain of $3,000 on the disposal of fixed assets and income of $75,000 from the sale of materials and others in the prior fiscal year.

Operating Loss – Operating loss from continuing operations was $5,347,000 for the year ended March 31, 2016, as compared to operating loss from continuing operations of $4,806,000 in the prior fiscal year.

On a segment basis, the operating loss in the plastic segment was $3,236,000 in the year ended March 31, 2016, as compared to an operating loss of $2,456,000 in fiscal 2015. The increase in operating loss in the plastic segment was mainly due to incurring other expense (net) in fiscal 2016 compared to incurring other income in fiscal 2015.

The electronic segment reported an operating loss of $2,111,000 in the year ended March 31, 2016, compared to an operating loss of $2,350,000 in fiscal 2015. The decrease in operating loss was largely due to an increase in sales turnover and gross margin as described above.

Non-operating income – Non-operating income from continuing operations for the year ended March 31, 2016 was $571,000, as compared to non-operating income from continuing operations of $2,553,000 in the prior fiscal year. The decrease was primarily due to decreases of $2,814,000 on the fair value of marketable securities, and of $163,000 in interest income, offsetting increases of $358,000 in dividend income, $424,000 in realized gain on sale of marketable securities, and $192,000 in rental income as compared to fiscal 2015.

Income Taxes – Income tax from continuing operations for the year ended March 31, 2016 was comprised of an income tax expense of $103,000 and a deferred tax provision of $55,000, as compared to an income tax expense of $92,000 and a deferred tax provision of $115,000 from continuing operations in the prior fiscal year.

On a segment basis, there was income tax expense of $50,000 and a deferred tax provision of $54,000 in the plastic segment for the year ended March 31, 2016, as compared to income tax expense of $49,000 and a deferred tax provision of $115,000 during the prior fiscal year. The income tax of the electronic segment was comprised of income tax expense of $54,000 for the year ended March 31, 2016, as compared to income tax expense of $43,000 in fiscal 2015.

Loss from continuing operations – The Company had a net loss from continuing operations of $4,934,000 for the year ended March 31, 2016, as compared to a net loss from continuing operations of $2,460,000 for the year ended March 31, 2015. The increase in net loss was mainly the result of decreases in other and non-operating income as described above.

Net loss for the plastic segment for the year ended March 31, 2016 totaled $2,776,000, as compared to a net loss of $505,000 for fiscal 2015. The increase in net loss in the plastic segment was mainly due to decreases in other and non-operating income described above.

Net loss for the electronic segment for the year ended March 31, 2016 was $2,158,000, compared to net loss of $1,955,000 for fiscal 2015. The increase in net loss in the electronic segment was mainly attributable to decrease in non-operating income as described above.

Loss from discontinued operations – During the fourth quarter of fiscal 2015, the Company closed down its metallic parts business unit and sold all of its assets. The operating results of the metallic parts business unit are reported as discontinued operations for all periods presented. We had historically reported the results of the metallic parts business unit as a separate segment. The continuing cash flows subsequent to its closure were not significant.

The results of the discontinued operations of metallic parts for the fiscal years ended March 31, 2015, 2016 and 2017 were as follows:

	(in thousands)		
	Year ended March 31,		
	2015	2016	2017
Net sales	$1	$ —	$ —
Loss from discontinued operations, before income taxes	$(348)	$ —	$ —
Income taxes	$—	$ —	$ —
Loss from discontinued operations, after income taxes	$(348)	$ —	$ —

Seasonality

The following table sets forth certain unaudited quarterly financial information sequentially for the four quarters in each of the years ended March 31, 2015 and March 31, 2016, and on a semi-annual basis for the year ended March 31, 2017 (in thousands):

Year Ended March 31,	
2015	**2016**

	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Net sales	$8,924	$10,193	$10,834	$8,126	$11,273	$12,375	$12,510	$8,410
Gross profit	865	695	942	934	765	1,337	1,418	1,273
Operating loss	(813)	(1,873)	(1,725)	(743)	(1,029)	(2,322)	(262)	(1,163)
Net income (loss)	14	(1,702)	(1,133)	13	(1,097)	(2,375)	(305)	(1,157)

(1) The sum of the unaudited quarterly financial data may not be equal to the respective figures as stated in the audited financial statements because of the posting of reclassifications.

(2) In fiscal year 2017, the Company adopted a semi-annual financial results reporting schedule, consistent with many other foreign issuers, in order to minimize corporate overhead. Prior to fiscal year 2017 the Company reported financial results on a quarterly basis.

	Year ended March 31, 2017	
	H1	H2
Net sales	$20,634	$23,888
Gross profit	2,947	4,502
Operating loss	(1,818)	(285)
Net income (loss)	711	665

The following table sets forth the same unaudited information presented in the above table but by quarterly comparisons by year in the two-year period ended March 31, 2016, and by semi-annual comparisons for theyear ended March 31, 2017(in thousands):

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	Three months ended							
	June 30,		**September 30,**		**December 31,**		**March 31,**	
	2014	**2015**	**2014**	**2015**	**2014**	**2015**	**2015**	**2016**
Net sales	$8,924	$11,273	$10,193	$12,375	$10,834	$12,510	$8,126	$8,410
Gross profit	865	765	695	1,337	942	1,418	934	1,273
Operating loss	(813)	(1,029)	(1,873)	(2,322)	(1,725)	(262)	(743)	(1,163)
Net income (loss)	14	(1,097)	(1,702)	(2,375)	(1,133)	(305)	13	(1,157)

(1) The sum of the unaudited quarterly financial data may not be equal to the respective figures as stated in the audited financial statements because of the posting of reclassifications.

(2) In fiscal year 2017, the Company adopted a semi-annual financial results reporting schedule, consistent with many other foreign issuers, in order to minimize corporate overhead. Prior to fiscal year 2017 the Company reported financial results on a quarterly basis.

	Six months ending	
	September 30, 2016	**March 31, 2017**
Net sales	$ 20,634	$23,888
Gross profit	2,947	4,502
Operating loss	(1,818)	(285)
Net income (loss)	711	665

The first calendar quarter (the fourth fiscal quarter ending March 31 of our fiscal year) is typically the Company's slowest sales period because, as is customary in China, the Company's manufacturing facilities in China are closed for two weeks for the Chinese New Year holidays. Through March 31, 2017, the Company has not experienced any other significant seasonal fluctuations.

Impact of Inflation

Historically, the Company focused upon increasing transaction volume in order to compensate for inflation in China, where virtually all of the Company's assets and employees are located and inflation in China had little impact on Deswell. However, inflation in China has recently affected the Company significantly.

The inflation rate in China rose 1.5% year-on-yearas of May of 2017. However, the Company's actual cost of operations has significantly exceeded the overall inflation rate in China. The rapid growth of China's economy in general has in the past few years increased the Company’s operating costs, including energy prices and labor costs. These increased costs have adversely affected the Company’s cost of operations, caused the Company to increase its prices, and resulted in the loss of some customers.

There is no fixed minimum wage which is applicable to all of China; local governments in China adopt different amounts based on the situation in their area. China’s Guangdong Province, where our manufacturing facilities are located, raised minimum wages by approximately 20% in May 2011 and another 19.1% in March 2013. Effective May 1, 2015, minimum wage levels across Guangdong Province, including Dongguan, where our manufacturing facilities are located, were increased by an average of 15.3%. Since then, there have been no adjustments made to the minimum wage in Guangdong Province.

Increases in wages also result in increases in our and other employer’s contributions for various mandatory social welfare benefits for Chinese employees that are based on percentages of their salaries. Continuing material increases in our cost of labor will continue to increase the Company’s operating costs and will adversely affect Deswell’s financial results unless it passes on such increases to customers by increasing the prices of products and services. The effect of increases in the prices of products and services would make the Company’s products more expensive in global markets, such as the United States and the European Union. This could result in the loss of customers, who may seek, and be able to obtain, products and services comparable to those Deswell offers in lower-cost regions of the world. If the Company does not increase prices to pass on the effect of increases in labor costs, Deswell's margins and profitability would suffer.

Because most of the Company's labor costs are incurred in China and therefore paid in RMB, the adverse effect on Deswell's business and financial results from increasing labor costs has in previous years been exacerbated by the appreciation in the exchange rate to the U.S. dollar, as is discussed in "Exchange Rates" immediately below. However, in fiscal 2016 and 2017, the RMB depreciated relative to the U.S. dollar, with the exchange rate mitigating rather than exacerbating the increasing labor costs experienced by the Company.

Exchange Rates

The Company's sales are mainly in United States dollars and Hong Kong dollars and its expenses are mainly in United States dollars, Hong Kong dollars and Chinese RMB.

The Hong Kong dollar has been pegged to the U.S. dollar at approximately 7.80 and has been relatively stable. The Hong Kong government may not continue to maintain the present currency exchange mechanism, which fixes the Hong Kong dollar at approximately 7.80 to each United States dollar and has not in the past presented a material currency exchange risk. Although announcements by Hong Kong's central bank indicate its intention to maintain the currency peg between the Hong Kong dollar and the U.S. dollar, if Hong Kong does change and follows China to a floating currency system or otherwise changes the exchange rate system of Hong Kong dollars to U.S. dollars, our margins and financial results could be adversely affected.

Between 1994 and July 2005, the market and official RMB rates were unified and the value of the RMB was essentially pegged to the U.S. dollar and was relatively stable. On July 21, 2005, the People's Bank of China adjusted the exchange rate of RMB to the U.S. dollar by linking the RMB to a basket of currencies and simultaneously setting the exchange rate of RMB to U.S. dollars, from 1:8.27, to a narrow band of around 1:8.11. The following chart illustrates the fluctuations since the July 31, 2005 adjustment of the RMB to the U.S. dollar by showing the exchange ratio at the end of each of Deswell's fiscal years from March 31, 2006 to March 31, 2017.

(1) RMB (yuan) to U.S. dollar data presented in this chart are the midpoint rates on March 31 of the year indicated as reported by "Historical Exchange Rates" at http://www.oanda.com/currency/historical-rates/.

We did not hedge our currency risk during the years ended March 31, 2015, 2016 and 2017 and at March 31, 2017, we had no open forward currency contracts. We continually review our hedging strategy and there can be no assurance that hedging techniques we may implement will be successful or will not result in charges to our results of operations.

Liquidity and Capital Resources