DESWELL INDUSTRIES INC
Form 20-F
July 08, 2005

Table of Contents

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 20-F

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:	Commission File Number:
March 31, 2005	0-26448

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

British Virgin Islands
(Jurisdiction of incorporation or organization)

17B, Edificio Comercial Rodrigues
599 Avenida da Praia Grande
Macao
(Address of principal executive offices)

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

Securities registered pursuant to Section 12(g) of the Act: Common shares, no par value per share

Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act: Common shares, no par value per share

As of March 31, 2005, there were 14,778,730 common shares of the registrant outstanding.

Indicate by check mark whether the registrant: (i) 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 (ii) has been subject to such filing requirements for the past 90 days.

Yes þ No o

Indicate by check mark which financial statement item the registrant has elected to follow:

Item 17 o Item 18 þ

TABLE OF CONTENTS

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 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.

As used in this Report, we, our, us, Deswell or the Company refers to Deswell Industries, Inc. and its subsidi unless the context otherwise indicates.

All share and per share information in this Report, has been adjusted to reflect the Company s three-for-two stock split effected in July 2002 and the Company s three-for-two stock split effected in March 2005.

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 as the Company is incorporated in the British Virgin Islands, where the currency is the United States dollar, and the functional currency of the Company s subsidiaries are Hong Kong dollar and Chinese renminbi. All dollar amounts ($) set forth in this Report are in United States dollars, the references to HK$ refer to Hong Kong dollars and RMB to Chinese renminbi.

Table of Contents

PART I

ITEM 1. IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISORS

Not applicable.

ITEM 2. OFFER STATISTICS AND EXPECTED TIMETABLE

Not applicable.

ITEM 3. KEY INFORMATION

Selected Financial Data [1]

The selected consolidated financial data set forth below should be read in conjunction with our consolidated financial statements and notes thereto included elsewhere in this Report. The selected income statement data for each of the three fiscal years in the period ended March 31, 2005, and the balance sheet data as of March 31, 2004 and 2005 are derived from our audited consolidated financial statements included in this Report. The selected income statement data for the years ended March 31, 2001 and 2002, and the balance sheet data as of March 31, 2001, 2002 and 2003 are derived from our audited consolidated financial statements, which are not included in this Report.

	(In thousands, except per share and percentage data) Year ended March 31,				
	2001	2002	2003	2004	2005
Income Statement Data					
Net sales	$ 80,847	$ 83,320	$ 90,905	$ 97,195	$ 125,590
Cost of sales	52,596	54,448	61,006	66,105	92,072
Gross profit	28,251	28,872	29,899	31,090	33,518
Selling, general and administrative expenses	15,414	14,939	15,354	14,718	15,759
Operating income	12,837	13,933	14,545	16,372	17,759
Interest expense	(6)	(26)	(6)	(16)	(12)
Other income, net	915	877	818	910	342
Income before income taxes	13,746	14,784	15,357	17,266	18,089
Income taxes	315	535	3,826	589	576
Income before minority interests	13,431	14,249	11,531	16,677	17,513
Minority interests	621	925	1,288	1,957	2,330
Net income	$ 12,810	$ 13,324	$ 10,243	14,720	15,183
Basic earnings per share (2)(3)	$ 1.06	$ 1.06	$ 0.79	$ 1.08	$ 1.04
	12,096	12,605	13,008	13,664	14,656

Average number of shares outstanding basic (2)(3)					
Diluted earnings per share (3)	$ 1.05	$ 1.05	$ 0.77	$ 1.04	$ 1.02
Average number of shares outstanding diluted (2)(3)	12,229	12,699	13,278	14,160	14,933
Statistical Data:					
Gross margin	34.9%	34.7%	32.9%	32.0%	26.7%
Operating margin	15.9%	16.7%	16.0%	16.8%	14.1%
Dividends per share (3)	$ 0.39	$ 0.57	$ 0.51	$ 0.63	$ 0.65

			At March 31,		
	2001	**2002**	**2003**	**2004**	**2005**
Balance Sheet Data					
Working capital	$ 47,356	$ 54,922	$ 58,223	$ 52,876	$ 57,576
Total assets	83,466	94,744	106,172	113,534	136,976
Long-term debt, less current portion					
Total debt		482			
Shareholders equity	63,877	69,651	81,846	89,730	104,767

(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) Basic EPS excludes dilution from potential common shares and is computed by dividing income available to common shareholders by the weighted-average number of common shares outstanding for the period. Diluted EPS reflects the potential dilution from potential common shares.

(3) Share and per share amounts presented above have been adjusted to reflect the three-for-two stock splits effected in July 2002 and March 2005 (see Note 11 of Notes to Consolidated Financial Statements).

Table of Contents

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 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 face numerous risks as a result of our operations in China.

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, which are discussed in more detail below.

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.

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 profitability, competitiveness and market position and jeopardize our ability to continue operations.

Our activities in China require business licenses. This requires a 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 or grant or renew our licenses. 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 profitability would be substantially impaired, our competitiveness and market position would be materially jeopardized and we may not be able to continue operations.

A fire, severe weather, flood, or other act of God could cause significant damage to our properties in China and disrupt our business operations.

Firefighting and disaster relief or assistance in China are primitive by Western standards. At March 31, 2005, we maintained fire, casualty and theft insurance aggregating approximately $44,371,000 covering certain of our stock in trade, goods and merchandise, furniture and equipment and factory buildings in China. 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, or other act of God or cause. We do not maintain any business interruption insurance.

Possible changes and uncertainties in economic policies in the Special Economic Zones of China in which we operate could harm our operations by eliminating benefits we currently enjoy.

As part of its economic reform, China has designated certain areas, including Shenzhen where we have certain manufacturing facilities, as Special Economic Zones. Foreign enterprises in these areas benefit from greater economic autonomy and more favorable tax treatment than enterprises in other parts of China. Changes in the policies or laws governing Special Economic Zones could eliminate these benefits. Moreover, economic reforms and growth in China have been more successful in certain provinces than others, and the continuation or increase of these disparities could affect the political or social stability of China.

Changes to Chinese tax laws and heightened efforts by the Chinese tax authorities to increase revenues could subject us to greater taxes.

Under applicable Chinese law, we can obtain and have obtained tax breaks by reinvesting profits of certain of our subsidiaries in China. For information on our income taxes, rates and concessions with respect to our Chinese operations, see Note 8 of Notes to Financial Statements. However, the Chinese tax system is subject to substantial uncertainties with respect to its interpretation and enforcement. Moreover, the Chinese government has attempted to augment its revenues through heightened tax collection efforts. Continued efforts by the Chinese government to increase tax revenues could result in decisions or interpretations of the tax laws by the Chinese tax authorities that would increase our future tax liabilities or deny us expected concessions or refunds.

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 are common in China. We could suffer losses from these practices if we are not successful in implementing and maintaining preventative measures.

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

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.

Changes in currency rates involving the Hong Kong dollar or Chinese renminbi could increase our expenses or cause economic or political problems affecting our business. Tariffs imposed as a result of China s refusal to adjust its currency would make our products exported to the United State more expensive.

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 renminbi. The Chinese 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 cause the Chinese renminbi to trade between 8.276 and 8.280 to the United States dollar for the last several years. Over the years, and especially in the last several months, there have been reports that the Chinese Government is under economic and political pressure from countries with which it trades to permit its currency to appreciate against the United States dollar. For example, lawmakers in the United States have threatened to impose high tariffs on Chinese imports if China does not adjust its currency. If the currency exchange mechanism between the Hong Kong dollar and the U.S. dollar is changed, our results of operations and financial condition could be materially adversely affected. Any material increase in the value of the Hong Kong dollar or Chinese renminbi relative to the U.S. dollar would increase our expenses when translated to US dollars and could make our products more expensive in global markets, such as the United States and the European Union. Tariffs imposed as a result of China s refusal to adjust its currency would make our products exported to the United State more expensive and could place us at a severe competitive disadvantage.

Our financial results could be adversely impacted by tax audits by the Hong Kong Inland Revenue Department on profits derived from activities of certain of our subsidiaries.

The Hong Kong Inland Revenue Department, or IRD, which is tax authority of the Hong Kong Government, is currently engaged in aggressive and frequent field audits and close and critical scrutiny of commercial transactions. For example, during 2003 through July 2003, the Company engaged in discussions with the IRD regarding whether Deswell should be assessed taxes on profits derived from activities of certain of its subsidiaries during the six fiscal years ended March 31, 2002, which the Company believed were conducted outside of Hong Kong and were not subject to a profits tax under the Hong Kong Inland Revenue Ordinance. While, based on consultations with Hong Kong tax experts, Deswell believes that its tax position for these years was sound and supportable, management nevertheless concluded that it would be in the Company s best interest to reach an immediate resolution of the tax issue with the IRD in order to avoid the expenditure of substantial time, effort and expense involved in proceedings that could extend years and to limit the assessment of taxes, interest and/or penalties that would be incurred if the Company did not prevail or sought to settle the dispute later. Accordingly, in June 2003 the Company made a proposal to settle the entire tax dispute and in July 2003, the IRD accepted the proposal. As a result, a provision of $3,532,000 was charged to the Company s consolidated income statements for year ended March 31, 2003 and this adversely impacted the Company s net income reported for the fourth quarter of, and the year ended, March 31, 2003. The Company believes, based on consultations with Hong Kong tax experts, that it has restructured the operations of its subsidiaries in order to strengthen further its tax position if audited by the IRD in the future for fiscal years after March 31, 2002. However, litigating with the IRD is inherently uncertain, lengthy, time consuming and expensive and there is no guarantee that the Company would prevail. Even if the Company believed it would prevail, Deswell might choose to settle future assessments for amounts in excess of the tax provisions it made for the years involved in order to eliminate the expense or uncertainty of challenging such assessments. In either event, Deswell s financial results could be adversely impacted.

Any future outbreak of severe acute respiratory syndrome or other diseases may have a negative impact on our business and operating results.

In the first calendar quarter of 2003, several economies in Asia, including Hong Kong, where our logistic support office and some of our customers are located, and southern China, where our factories are located, were affected by the outbreak of severe acute respiratory syndrome, or SARS. If there is a recurrence of an outbreak of SARS, it may adversely affect our business and operating results. For example, a future SARS outbreak could result in quarantines or closure to our office in Hong Kong or factories in China if our employees are infected with SARS and ongoing concerns regarding SARS, particularly its effect on travel, could negatively impact our customers and suppliers based in Hong Kong or China and our business and operating results.

In addition, there has recently been an outbreak of avian influenza in humans in Asian countries, including Vietnam, South Korea and Japan, which has proven fatal in some instances. As the human death toll continues to grow, many are concerned that the virus will mutate and trigger a human pandemic. If such an outbreak were to spread to southern China, it may adversely affect our business operating results.

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

Our administration and accounting office 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.

A recent labor shortage in southern China could adversely affect our gross margins or decrease revenue.

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 inexpensive labor rates as compared to Hong Kong. Historically, there has been an abundance of labor in southern China, but, according to a recent Chinese government survey, factories in southern China are facing a labor shortage as migrant workers seek better wages and working conditions elsewhere. If this trend continues, the Company s operations could be adversely affected by, for example, preventing the Company from manufacturing at peak capacity or forcing the Company to increase wages to attract necessary workers. This could result in lower revenues or increased manufacturing costs, which would adversely affect gross margins.

We are dependent on a few major customers and have no long-term contracts with them. Our sales would substantially decrease and we would suffer decreases in net income or losses if we lose any of our major customers, if they substantially reduce their orders or if they are unable to pay us.

Historically, a substantial percentage of our sales have been to a small number of customers. Our four largest customers during the year ended March 31, 2005 were Digidesign Inc., Epson Precision (H.K.) Limited, Line 6 Manufacturing and VTech Telecommunications Limited. Each of these customers individually accounted for 10% or more of our total net sales during the year ended March 31, 2005 and accounted for an aggregate of 47.2%, 57.6% and 64.6%, respectively, of our total net sales during the years ended March 31, 2003, 2004 and 2005, respectively. 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 may fluctuate from time to time. The loss of any one of our largest customers or a substantial reduction in orders from any of them would adversely impact our sales and decrease our net income or cause us to incur losses unless and until we were able to replace the customer or order with one or more of comparable size. In addition, a substantial portion of our sales is made on credit and our results of operations would be adversely affected if a major customer were unable to pay for our products or services.

We have no long-term contracts to obtain plastic resins and our profit margins and net income 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, 2003, 2004 and 2005:

	Year ended March 31,		
	2003	**2004**	**2005**
Resins cost as a % of plastic products sold	53%	52%	58%
Resins cost as a % of total cost of goods sold	25%	25%	24%

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. 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 profit margins. A significant increase in resin prices in the future could likewise adversely affect our profit margins and results of operations.

Table of Contents

We are facing increasing competition, which has had an adverse effect on our gross profit margins.

Over the last few years we have been forced to lower our prices as a result of increasing competition in our market segments. This has resulted in lower gross profit margins, which have declined by:

16.6% from 32.0% during the year ended March 31, 2004, to 26.7% during the year ended March 31, 2005,

2.7%, from 32.9% during the year ended March 31, 2003, to 32.0% during the year ended March 31, 2004, and

5.2%, from 34.7% during the year ended March 31, 2002, to 32.9% during the year ended March 31, 2003,

If we are forced to continue to lower our prices and are unable to offset this decrease by increasing our sales volumes, our net sales and gross margins will decline. If we cannot stem the decline in our gross margins, our financial position may be harmed and our stock price may decrease.

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.

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

We are incorporated in the British Virgin Islands and have subsidiaries incorporated in the British Virgin Islands, Hong Kong, Macao, Samoa, Malaysia and China. Our administrative and accounting office is located in Macao. We manufacture all of our products in China. As of March 31, 2005, approximately 97% of the net book value of our total identifiable fixed assets was located in China. We sell our products to customers principally in China, the United States, Europe and Hong Kong. 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 decrease the profitability of our operations in that region.

Our loss of certain members of our senior management could cause disruptions in our business and harm our customer relationships thereby adversely affecting sales.

We depend to a large extent on the abilities and continued participation of

Richard Lau, our Chairman of the Board and Chief Executive Officer;

C. P. Li, our Executive Director, General Manager in charge of manufacturing and administrative operations for plastic products, and Chief Financial Officer;

C. W. Leung, Executive Director of Engineering in charge of the mold division and engineering for our plastic manufacturing operations;

S. K. Lee, our Director of Administration and Marketing and General Manager in charge of administrative and marketing operations for electronic and metallic products; and

M. C. Tam, our Director of Engineering and Manufacturing, in charge of manufacturing and operations for electronic and metallic products.

Messrs. Lau, Li and Leung founded our company and have played integral roles in the management, growth and development of our company in general and our plastic injection molding business in particular. They have developed and maintain relationships with several of our key customers in our plastic injection molding business. Mr. S. K. Lee and Mr. M. C. Tam founded our electronic products manufacturing business and have developed and continue to manage it since we acquired control of the business from them. We have no employment contracts with any of these executives and their loss would require us to find executives suitable to replace them, which could be difficult and disruptive to our business. Customers with whom they have relationships may cease to deal with us or choose to use a competitor for a greater portion of their business, resulting in our loss of sales.

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

Our senior management as a group, each of whom are also members and constitute a majority of our board of directors, directly or indirectly through an affiliated company beneficially own approximately 31.0% our shares at June 28, 2005. As a result, acting together they may be able to control, and they can substantially influence, 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.

If we do not receive an unqualified opinion on the adequacy of our internal control over financial reporting, as required by Section 404 of the Sarbanes-Oxley Act of 2002 (currently required for our fiscal year ending March 31, 2007 and thereafter), investors could lose confidence in the reliability of our financial statements, which could result in a decrease in the value of our shares.

As directed by Section 404 of the Sarbanes-Oxley Act of 2002, the SEC adopted rules requiring public companies to include a report of management on the company s internal control structure and procedures over financial reporting in their annual reports on Form 20-F that contains an assessment by management of the effectiveness of the company s internal control structure and procedures over financial reporting. In addition, the public accounting firm auditing the company s financial statements must attest to and report on management s assessment of the effectiveness of the company s internal control structure and procedures over financial reporting. While we intend to conduct a rigorous review of our internal control structure and procedures over financial reporting in order to assure compliance with Section 404 requirements by the deadline applicable to us (currently March 31, 2007 and fiscal years thereafter), if our independent auditors interpret Section 404 requirements and the related rules and regulations differently from us or if our independent auditors are not satisfied with our internal control structure and procedures over financial reporting or with the level at which it is documented, operated or reviewed, they may decline to attest to management s assessment or issue a qualified report. This could result in an adverse reaction in the financial markets due to a loss of confidence in the reliability of our financial statements, which could cause the market price of our shares to decline.

Legislative actions and potential new accounting pronouncements are likely to impact our future financial position and results of operations and in the case of FASB s new pronouncement regarding the expensing of stock options will adversely impact our financial results.

There have been regulatory changes, including the Sarbanes-Oxley Act of 2002, new SEC regulations and Nasdaq Stock Market rules and there may be potential new accounting pronouncements or regulatory rulings, which will have an impact on our future financial position and results of operations. These regulatory changes and other legislative initiatives have increased general and administrative costs. The Financial Accounting Standards Board s recent change to mandate the expensing of stock options will require us to record charges to earnings for stock option grants to employees and directors and will adversely affect our financial results after we implement the new pronouncement, which we expect will be in the quarter ending June 30, 2006 unless the compliance date to implement this accounting change is again postponed by the SEC.

Table of Contents

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 British Virgin Islands, our Memorandum and Articles of Association, which are the terms used in the British Virgin Islands 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 or to create from time to time and issue one or more classes of preference shares (which are analogous to preferred stock of corporations organized in the United States). Our board s ability to amend our charter documents without shareholder approval, including its ability to create and issue preference 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 a foreign private issuer, we are exempt 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;

and 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).

In addition, because the Company is 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 Market may not be applied to us or their effectiveness may be delayed beyond the effective date applicable to domestic companies.

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

ITEM 4. INFORMATION ON THE COMPANY

History and Development of Deswell

The Company was incorporated in December 1993 as a limited liability International Business Company under the laws of the British Virgin Islands. The Company s registered agent in the British Virgin Islands is HWR Services Limited, P.O. Box 71, Craigmuir Chambers, Road Town, Tortola, British Virgin Islands. The Company s principal administrative office is located in 17B, Edificio Comercial Rodrigues, 599 Avenida da Praia Grande, Macao, and its telephone number is (853) 322096 and its facsimile number is (853) 323265.

Deswell developed from the initial incorporation of Jetcrown Industrial Limited (JIL), a Hong Kong limited liability company, in February 1987. Richard Lau, C. P. Li and C. W. Leung founded JIL to manufacture injection-molded plastic parts for OEMs and contract manufacturers. JIL is the ultimate predecessor of the Company as restructured in March 1994. In January 1990, Jetcrown Industrial (Shenzhen) Limited, a limited liability China foreign operation (Jetcrown Shenzhen), was organized to conduct the Company s manufacturing operations in China and JIL s manufacturing operations were relocated to China in 1990. Marcon Enterprises Limited, a British Virgin Islands International Business Company (Marcon), was organized in July 1991 to hold the beneficial ownership of Jetcrown Shenzhen and to supervise the latter s manufacturing operations. Marcon has been dormant since April 2003 and was sold to a third party in October 2003. Richtex Services Limited (Richtex), a Hong Kong limited liability company, was organized in November 1991 to serve as Marcon s local agent and to discharge Marcon s duties to supervise the manufacturing operations of Jetcrown Shenzhen. Richtex was deregistered from the Companies Registry in March 2004. JIL has been dormant since January 2004.

In October 1992, the Company purchased a controlling interest of the outstanding stock of Kwanasia Electronics Company Limited, a Hong Kong limited liability company (Kwanasia) and an independent contract manufacturer of electronic products, components and subassemblies, from two former shareholders. In December 1994, the Company increased its interest in Kwanasia to 51% of the outstanding Kwanasia shares by purchasing the requisite stock from Mr. S. K. Lee and Mr. M. C. Tam, Kwanasia s then remaining two shareholders. The total price paid by the Company in 1994 for its majority interest in Kwanasia s shares was approximately $517,000, which was paid in cash.

Kwanasia originally conducted the Company s contract electronic manufacturing operations through a joint venture enterprise (organized as a limited liability China company) called Shenzhen Kwanam Electronics, Co., Ltd. (Shenzhen Kwanam). Shenzhen Kwanam was initially established as a 70%-30% joint venture company pursuant to a Joint Venture Agreement between Kwanasia and Commercial Trading Corporation (CTC), an independent Chinese party. However, the parties to the Joint Venture Agreement subsequently elected to modify such arrangement. Such modification took various forms but in each case essentially provided that Kwanasia and its successor (through the subsidiaries which held the joint venture interest) would have in substance a 100% economic interest in the joint venture enterprise, subject to a RMB60,000 (approximately $7,200 at May 30, 1996) annual payment by it to CTC. In May 1996, Kwanasia and CTC agreed that Kwanasia would purchase CTC s 30% interest in Shenzhen Kwanam (the Buy-out Agreement) for RMB180,000 (approximately $22,000 at May 30, 1996, the day the purchase price was paid). This transaction was completed during the year ended March 31, 1998 and resulted in Shenzhen Kwanam becoming a wholly owned subsidiary. Following reorganization in electronic operations and its move into a new manufacturing plant in Dongguan, China, the manufacturing operations of Shenzhen Kwanam were switched to another wholly owned subsidiary, Dongguan Kwan Hong Electronics Co. Ltd. (Kwan Hong) commencing April 1, 1999. Kwan Hong was initially established as an 85%-15% joint venture company pursuant to a Joint Venture Agreement dated January 31, 1997 between Kwanasia and Dongguan Cheung On Lang Wang Electronics Development Company (Lang Wang), an independent Chinese party. Pursuant to a subsequent supplemental agreement signed on February 27, 1997 between Kwanasia and Lang Wang, both parties agreed that Kwanasia would have in substance a 100% economic interest in the joint venture enterprise with Lang Wang guaranteed an annual rental income for the buy out. In March 2004, Kwanasia s 85% interest in Kwan Hong was transferred to Integrated International Limited (see discussion of Integrated below) and in May 2004, Lang Wang s 15% interest in Kwan Hong was also transferred to Hong Xin Electronics Company Limited (Hong Xin), a new independent Chinese party. The registrations of Integrated and Hong Xin with the Chinese Government were approved in April and July 2004, respectively. In a supplemental agreement signed on July 1, 2004, both parties agreed that Intergrated s wholly-owned subsidiary would have in substance a 100% economic interest in the joint venture enterprise with Hong Xin guaranteed an annual rental income for the buy out.

The Company s incorporation in the British Virgin Islands in December 1993 was part of a restructuring in which Deswell Industries, Inc. was organized to become the ultimate parent holding company of the companies engaged in actual business operations and to spin off to Messrs. Lau, Li and Leung other companies that hold real estate in Hong Kong. This restructuring, which was completed in March 1994, involved the following steps. First, on December 13, 1993, the Company (i) allotted a total of 2,539 common shares to provide the initial capital of the Company and (ii) acquired the entire issued share capital of Leesha Holdings Limited, the former ultimate parent company, in exchange for which it issued a total of 3,387,304 common shares. These shares were issued in equal portions to Messrs. Lau, Li and Leung, the former shareholders of Leesha Holdings Limited. Second, on March 22, 1994, the Company acquired the entire issued share capitals of JIL, Marcon (including its interest in Jetcrown Shenzhen) and Richtex from Leesha Enterprises Limited, a wholly owned subsidiary of Leesha Holdings Limited and a second-tier holding company, in exchange for which the Company issued an aggregate of 7,618 common shares in equal proportions to Messrs. Lau, Li and Leung. Third, also on March 22, 1994, the Company acquired Leesha Enterprises Limited s 50.00005% interest in Kwanasia in exchange for the issue of 2,539 common shares in the Company in equal proportions to Messrs. Lau, Li and Leung and the assignment of a debt due to JIL of approximately $465,000 relating to the original purchase of Kwanasia. Finally, on March 22, 1994, the Company made a distribution in specie of the entire share capital of Leesha Holdings Limited to Messrs. Lau, Li and Leung.

Table of Contents

The immediate effect of this restructuring was that the Company wholly owned JIL, Marcon (which wholly owned Jetcrown Shenzhen) and Richtex and also owned 51% of the outstanding capital stock of Kwanasia (which, in turn had a 100% economic interest in Shenzhen Kwanam). Messrs. Lee and Tam owned the balance of Kwanasia. In 1995, this restructuring was fine-tuned further, with the Company forming two new corporations, Union International Limited (which changed its name to Integrated International Limited on May 1, 1996) (Integrated) and Oriental Enterprises Limited (which changed its name to Bright Oriental Enterprises Limited on May 1, 1996) (Oriental Enterprises), both corporations organized under the laws of Samoa. Integrated issued its shares proportionately to Deswell and Messrs. Lee and Tam in exchange for all outstanding capital stock of Kwanasia respectively held by them, with the result that through February 1998, Integrated was 51%-owned by Deswell and 49%-owned by Messrs. Lee and Tam.

In March 1998, Messrs. Lee and Tam together sold 5% shareholding interest in Integrated to Micropower Enterprises, Ltd. In January 2003, the Company increased its interest in Integrated to 71% by purchasing an additional 20% from Messrs. Lee and Tam in exchange for the issuance to Messrs. Lee and Tam of an aggregate of 251,880 common shares of Deswell. In April 2005, the Company increased its interest in Integrated to 76% by purchasing the 5% interest owned by Micropower Enterprises Ltd. in exchange for the issuance to Micropower Enterprises Ltd. of 120,000 common shares of Deswell. Integrated in turn owns all of the outstanding capital stock of Kwanasia. Messrs. Lee and Tam still own, in equal shares, 24% of the capital stock of Integrated and continue to serve as the executives in charge of administrative and manufacturing operations, respectively, for the Company s contract manufacturing operations for electronic products and subassemblies. See Item 6 Directors, Senior Management and Employees.

As part of the Company s restructuring, Oriental Enterprises was organized as a wholly-owned subsidiary of Integrated and it was assigned Kwanasia s joint venture interest in Shenzhen Kwanam and assumed Kwanasia s rights and responsibilities under the Shenzhen Kwanam joint venture. With the completion during the year ended March 31, 1998 of the purchase of CTC s 30% joint venture interest in Shenzhen Kwanam pursuant to the Buy-out Agreement, Shenzhen Kwanam became a wholly owned subsidiary of Oriental Enterprises. Shenzhen Kwanam was closed on January 1, 2004 upon the expiration of its 10-year business license. Oriental Enterprises has been dormant since April 2002 and was sold to a third party in October 2003.

In October 1996, Integrated acquired a 64.9% interest in Kwanta Precision Metal Products Co., Ltd. (Kwanta), a corporation organized under the laws of Hong Kong, for $64,000, which was paid in cash. In April and July 1999, Integrated acquired the remaining 35.1% interest in Kwanta for $6,000, which was paid in cash. Kwanta manufactures metallic molds and accessory parts for use in audio equipment, copying machines and fax machines. Kwanta supplies metallic molds for the Company s plastic and electronic operations and manufactures metal parts for OEMs and contract manufacturers, including the Company. Since September 2002, the Company s metallic manufacturing operation was shifted to Kwan Hong and Kwanta has been dormant since then.

In January 1999, the Company organized Star Peace Limited, a British Virgin Islands International Business Company, in order to hold securities the Company acquires for investment.

In January 2000, the Company organized Blue Collar Holdings Limited (Blue Collar), a British Virgin Islands International Business Company to hold the beneficial ownership of Jetcrown Industrial (Dongguan) Limited (Jetcrown Dongguan). Jetcrown Dongguan, a limited liability China Foreign Enterprise registered in January 2000, was organized to conduct the Company s plastic injection molding manufacturing operations in Dongguan, China. Jetcrown Dongguan commenced production in July 2000.

In April 2000, Integrated organized Digiwave Limited (originally named Wisetop Technology Limited), a limited liability Hong Kong Company, to carry on original design manufacturing, or ODM, in connection with our electronic manufacturing business. Digiwave was deregistered from the Companies Registry in March 2004.

In June 2000, the Company organized Jetcrown Industrial Sdn. Bhd. (JISB), a limited liability Malaysian Company, to establish a representative office in Dongguan, China to handle our overseas plastic injection product sales. On May 22, 2001, the Company s representative office successfully obtained a registration certificate to allow it to do business from the Chinese Government and it commenced business in August 2001. The representative office was deregistered with the Chinese Government in January 2004 and JISB has been dormant since December 2003.

In August 2001, the Company organized Jetcrown & Kwanasia (OEM) Specialist Limited (J&K OEM), a limited liability Hong Kong Company, to conduct marketing for Deswell s plastic and electronic businesses. The capital stock of J&K OEM was owned 51% by Deswell, 39% by Dickson Lam, Deswell s former Director of Marketing for plastic and electronic products, and 10% by two other individuals, who were employees of J&K OEM. In March 2003, the Company reorganized J&K OEM s operations by organizing Triumph Wise Technology Limited (Triumph Wise), a British Virgin Islands International Business Company, and in August 2003 also incorporated a new Macao company, namely, J&K (OEM) Specialist (Macao Commercial Offshore) Limited (J&KMCO), that is wholly-owned by Triumph Wise. The capital stock of Triumph Wise is owned 51% by Deswell, 39% by Dickson Lam and 10% by two other individuals, who are now employees of J&KMCO. In August 2003, J&KMCO obtained business license approval to carry out offshore marketing service activities in Macao. J&K OEM s operations were transferred to J&KMCO in September 2003 and J&K OEM has been dormant since then. In March 2005, the Hong Kong Companies Registry approved the application to deregister J&K OEM from the Companies Registry. J&KMCO has been dormant since January 2005 following the retirement of Dickson Lam and in June 2005, the Macao Company Registry approved the application of Deswell and the minority shareholders of Triumph Wise to deregister J&KMCO from the Company Registry.

In March 2003, Deswell also organized Rainbow Hill Limited, a 100% owned British Virgin Islands International Business Company, in order to establish another new 100% owned Macao incorporated company, namely Jetcrown Industrial (Macao Commercial Offshore) Limited (JIMCO). In August 2003, JIMCO was incorporated and obtained business license approval to carry out offshore trading activities in Macao.

In October 2003, Deswell organized Ideatop Holdings Limited (Ideatop), a British Virgin Islands International Business Company to hold the beneficial ownership of Jetcrown Shenzhen. The registration of Ideatop with the Chinese Government was approved in December 2003. In September 2004, Ideatop reinvested retained earnings of $1,800,000 from Jetcrown Shenzhen to Jetcrown Donnguan, a sister subsidiary. At the same time, Ideatop also invested an additional cash capital of $1,800,000 in Jetcrown Dongguan, making its total investment holdings in Jetcrown Dongguan to approximately 26.1%. As a result, Blue Collar s holdings in Jetcrown Donnguan were reduced from 100% to approximately 73.9%.

In October 2003, the Company also organized Joint Harvest Industries Limited, a British Virgin Islands International Business Company and 100% owned by Integrated, in order to establish another new 100% owned Macao incorporated company, namely Kwanasia Electronics (Macao Commercial Offshore) Limited (KEMCO). In April 2004, KEMCO was incorporated and obtained business license approval to carry out offshore trading activities in Macao. Kwanasia has been dormant since June 2004 when KEMCO commenced operations.

In December 2003, the Company also organized Spring Fountain Investments Limited, a British Virgin Islands International Business Company and 100% owned by Integrated for investment holding purpose.

Organizational Structure

The following chart illustrates the organizational structure of the Company and its active subsidiaries at March 31, 2005.

Table of Contents

Capital Expenditures

Principal capital expenditures and divestitures made by Deswell during the three years in the period ended March 31, 2005 include the following:

	2003	2004	2005
Purchase of property, plant and equipment	$ 9,731,000	$ 19,862,000	$ 17,003,000
Proceeds from the sale of property, plant and equipment	127,000	430,000	36,000

Principal capital expenditures made and currently in progress relate to improvements we are constructing and have constructed on the land we purchased in Dongguan, China to build a new factory. The construction of our new Dongguan factory and dormitories is planned to occur in three to four phases. The pace of construction depends on our financial situation and future operating results.

Through March 31, 2005, Deswell spent an aggregate of approximately $7.5 million on the first phase of construction of its new plastic injection molding plant. The facility comprises approximately 440,000 square feet of factory space, an 85,000 square foot amenity center and 95,000 square feet of dormitory space. Construction began in October 2001 and was completed in March 2003 with interior build-out finished in June 2003. After installation of machinery and final touch up, Phase I of the new factory became operational at the end of November 2003. During the same period, approximately $14.6 million were used to expand the Company s injection molding and tool-making capacity through the purchase of additional injection molding and tooling machinery and $6.4 million were used to acquire and install furniture and fixtures for operations.

Following completion of space built through Phase I, we spent an aggregate of approximately $6.5 million for the second phase of construction, which comprises an additional two factory building units covering approximately 220,000 square feet and three additional dormitory units of 216,000 square feet. Phase III of construction, with a planned investment of $10 million, will consist of an approximate 133,000 square foot office building, an additional 377,000 square feet of factory space and one additional dormitory unit of 120,000 square feet. Phase IV of construction, which will consist of an additional two dormitory units and two other buildings, is planned for the long-term, with construction to begin following completion of Phase III, as resources become available.

In July 2003, Deswell s electronic & metallic subsidiary completed the $4.1 million acquisition of 240,000 square feet of land and 400,000 square feet of factory buildings and accommodations in Cheung On, Dongguan. These premises were previously leased from a local government unit for the Company s electronics and metallic operations.

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. However, we may choose to obtain debt or equity financing if we believe it appropriate to accelerate the phases of construction of our new factory.

Business Overview

Introduction to Deswell

The Company is 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. The Company conducts all of its manufacturing activities at separate plastics, electronics and metallic operation factories located in the People s Republic of China.

The Company produces 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

- cases and key tops for personal organizers;
- cases for flashlights, telephones, paging machines, projectors and alarm clocks;
- grips and rods for fishing tackle;
- toner cartridges and cases for photocopy machines;
- parts for electrical products such as air-conditioning and ventilators;
- parts for audio equipment;
- double injection caps and baby products;
- laser key caps; and
- automobile components.

Table of Contents

Electronic products manufactured by the Company include

complex printed circuit board assemblies using surface mount (SMT), ball grip assembly (BGA) and pin-through-hole (PTH) interconnection technologies and

finished products which include

- Ø telecommunication products such as special purpose telephones used as a private automated branch exchange (IPBX), a network terminal and an internet platform etc.,
- Ø IP switches, routers, and
- Ø sophisticated professional audio equipment such as power amplifiers, digital mixers, digital signal processors, etc.

Metal products manufactured by the Company include metallic molds and accessory parts used in audio equipment, telephones, copying machines, pay telephones, multimedia stations, automatic teller machines, etc.

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 metal 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, as a result of increased competition, Deswell has been forced to reduce the sales prices of its products during the years ended March 31, 2003, 2004 and 2005, which has resulted in lower gross profit margins during these years.

Industry Overview

Management believes that the injection molding and metal molds 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 and metal manufacturing 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.

16

Table of Contents

Operations

Plastic Injection Molding

Plastic injection molding manufacturing accounted for 54.9%, 54.6% and 47.5% of the Company s total sales during the years ended March 31, 2003, 2004 and 2005, respectively. At March 31, 2005, the Company conducted its plastic manufacturing operations in approximately 311,000 and 693,000 square feet of factory space in its factories located in Shekou, Shenzhen, China and Dongguan, Guangzhou, China, respectively.

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 25 to 75 days, depending on the size and complexity of the mold. Mold making requires specialized machines and is capital intensive. At March 31, 2005, the Company used 29 EDMs (electrical discharge machines), 30 CNC (computer numerical control) milling machines and 85 NC (numerical control) milling machines in the mold-making process.

Deswell is continually adding equipment to expand its mold making and injection molding capabilities. During February to April 2002, the Company purchased 12 additional injection-molding machines with clamping force of 365 to 550 tons for approximately $1.5 million. These new injection-molding machines were installed in July 2002. In December 2002, the Company purchased five additional sets of injection-molding machines with clamping force of 368 to 650 tons for approximately $1 million. These new injection-molding machines, two of which have gas injection functionality, were installed in March 2003. In March 2003, the Company purchased four sets of precision double injection molding machines and one additional injection-molding machine with clamping force of 650 tons for an aggregate of approximately $1 million. These new injection-molding machines were installed in March and July 2003.

During the year ended March 31, 2004, the Company purchased and installed approximately $3.6 million worth of small- to medium-size machines and equipment, including 102 sets of Chen Hsong hydraulic injection machines with a clamping force of 55 tons to 218 tons; five sets of double-injection machines with a clamping force of 200 tons; nine sets of Fanuc electric precision-injection machines with a clamping force of 75 tons to 140 tons; four sets of Sumitomo high-speed precision-injection machines with a clamping force of 75 tons to 100 tons; two sets of high-precision large Makino electric discharge machines; and two sets of high-precision Mitsubishi wire-cut machines.

During the year ended March 31, 2005, the Company continued to expand its production capabilities, purchasing and installing approximately $2.9 million of machines and equipment, including four sets of EDMs; five sets of CNC milling machines; seven sets of NC milling machines; sixteen sets of Chen Hsong hydraulic injection machines with clamping force of 128 tons to 268 tons; and six sets of injection molding machines with clamping force of 85 to 200 tons, replacing 10 sets of old injection machines and one set of EDMs.

Molds produced by the Company generally weigh from 220 to 12,000 pounds and generally cost between $3,000 and $500,000.

The customer generally bears the cost of producing the molds and, as is customary in the industry, the customers own them. However, the Company maintains and stores the molds at its factory for use in production and it is the Company s policy not to make molds for customers unless the customer undertakes to store its molds at the Company s factory and uses the Company to manufacture the related parts. In this way, the Company seeks to use its mold-making expertise to create dependence on the Company for the customer s parts requirements.

Table of Contents

During the year ended March 31, 2005, the Company made on average about 70 to 100 different molds every month. 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, 2005, the Company had 368 injection molding machines, ranging from 50 to 1,600 tons of clamping force, with most machines in the range of from 80 to 100 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 is generally conducted 24 hours a day, five to seven days per week, other than 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.

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 216,000 square feet of factory space at March 31, 2005 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 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, 2003, 2004 and 2005, manufacturing of electronic products accounted for approximately 42.0%, 41.2% and 48.1%, respectively, of the Company s total sales. During the same periods, manufacturing of finished products accounted for 97%, 99% and 99%, respectively, of electronic product sales and assembling of printed circuit boards accounted for the balance of such sales during those periods.

In assembling printed circuit boards the Company purchases printed circuit boards, surface mounted components and chips and uses PTH, BGA and SMT 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 shorten 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.

Table of Contents

Metal Parts Manufacturing

In an aggregate of approximately 117,000 square feet of factory space at March 31, 2005 located at facilities in Dongguan, China next to the Company s electronic products assembly facilities, Deswell s metal forming division manufactures metallic molds and accessory parts for use in audio equipment, routers, payphones, multimedia stations and ATMs. The Company s metal molds and metal parts (products) manufacturing accounted for approximately 3.1%, 4.2% and 4.4% of Deswell s total sales during the years ended March 31, 2003, 2004 and 2005, respectively.

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..

Plastic, electronic and metal products manufactured and assembled at the Company s facilities have a low level of product defects, and aggregate returns represented less than 3% of total net sales during each of the years ended March 31, 2003, 2004 and 2005.

In 1995, the Company earned ISO 9001 certifications for both its plastic and electronic products manufacturing operations. In April 2000, the Company also received ISO 9002 for its metal manufacturing operation. 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 2003, the Company s plastic injection manufacturing plant in Shenzhen obtained ISO 14001 certification, which evidences that the Company s environmental management standards or EMS meet established international standards. In August 2004, the Company s plastic injection manufacturing plant in Dongguan also obtained ISO 14001 certification. 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 corner stone standard of the ISO 14000 series. The Company s electronic and metallic manufacturing plant is in the process of seeking ISO 14001 certification.

The Company was working toward having its plastic injection manufacturing plant obtain QS 9000 Certification but before completing that process elected to seek ISO/TS 16949 Certification. ISO/TS 16949 is an ISO Technical Specification. This specification aligns existing American (QS-9000), German (VDA6.1), French (EAQF) and Italian (AVSQ) automotive quality systems standards within the global automotive industry. Together with ISO 9001:2000, 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. The Company expects to achieve ISO/TS 16949 Certificate by the end of 2005.

Table of Contents

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), which in the years ended March 31, 2003, 2004 and 2005 averaged approximately 53%, 50% and 58%, respectively, of the Company s cost of plastic products sold and 25%, 24% and 24%, respectively, of the Company s total cost of goods sold. Because plastic resins are commodity products, the Company selects its suppliers primarily based on price. The Company has no long-term supply agreements for plastic resins. The Company currently obtains its plastic resins from suppliers in Hong Kong, Japan and Taiwan and normally maintains a three to four month inventory supply.

The Company used in excess of 13,573,000 pounds of plastic resins during the year ended March 31, 2005. Management believes that the Company s large volume purchases of plastic resin have generally resulted in lower unit raw material costs and generally has 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.

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. The Company purchases over 500 different component parts from more than 100 suppliers and is not dependent upon any single supplier for any essential component. The Company purchases from suppliers in Japan, Taiwan, Korea, Hong Kong and elsewhere. At various times there have been shortages of parts in the electronics industry, and certain components, including PCBs and semiconductors, have been subject to limited allocations. 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.

Raw Metal. The primary materials used by the Company in metal molds and parts manufacturing are various metals, but purchases of raw metal were immaterial to the Company s total operations during the years ended March 31, 2003, 2004 and 2005. Typically the Company buys metals from a variety of suppliers in Hong Kong and China and has no long-term contracts with metal suppliers.

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.

20

Table of Contents

Customers and Marketing

The Company s customers are OEMs and contract manufacturers. The Company sells its products in Asia (Hong Kong, Japan and China), the United States and Europe (Germany, United Kingdom, France and Italy). 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 16 of Notes to Consolidated Financial Statements for the dollar amounts of export sales by geographic area for each of the years ended March 31, 2003, 2004 and 2005. Net sales as a percentage of total sales to customers by geographic area consisted of the following for the years ended March 31, 2003, 2004 and 2005:

Geographic areas	**2003**	**2004**	**2005**
China	58.9%	51.6%	44.8%
United States	28.5	38.4	40.5
Europe	8.2	5.9	10.9
Hong Kong	3.1	2.3	0.8
Others	1.3	1.8	3.0
Total	100.0%	100.0%	100.0%

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 advertise in trade publications such as *Modern Plastics International* and *Injection Molding*. Collecting information from trade-show, as well as websites, Deswell s marketing staffs 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.

Major Customers

The table below sets forth each of the Company s customers which accounted for 10% or more of net sales during the year ended March 31, 2005 the products purchased and the percentage of total Company net sales accounted for by such customers during the years ended March 31, 2003, 2004 and 2005.

		Year ended March 31,		
Customer	**Product**	**2003**	**2004**	**2005**
Digidesign, Inc.	Professional audio equipments	13.5%	17.8%	19.1%
Epson Precision (H.K.) Limited	Plastic components	22.3%	15.4%	18.5%
Line 6 Manufacturing	Professional audio equipments	0.0%	*	14.9%
VTech Telecommunications Limited	Telephones and organizers	11.6%	17.6%	12.1%

* Less than 10%.

The Company s success will depend 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. If the Company was to lose any customers who account for a material portion of total net sales, or if any of these customers were to decrease substantially their purchases from the Company, the Company s revenues, earnings and financial position would be materially and adversely affected. The Company s dependence on these customers is expected to continue in the foreseeable future.

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 and metallic products are primarily made on credit terms, with payment in Hong Kong dollars expected within 30 to 60 days of shipment. Sales of electronic products are typically based on 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 difficulty in being paid by its major customers, there can be no assurance that the Company s favorable collection experience will continue in every case or at all. The Company could be adversely affected if a major customer were unable to pay for the Company s products or services.

Competition

Management believes that the plastic injection molding, contract electronic manufacturing and metal molds and accessories industries are each highly fragmented, although it is not aware of any empirical data defining the business segments in China. Plastic injection molding and metal molds and accessories manufacturing are characterized by a large number of relatively small operators and divisions of larger companies and contract electronic manufacturing by numerous independent manufacturers whose capabilities are evaluated by customers against each other and against the merits of in-house production. Competition in each industry is intense and many competitors in each industry are larger and have greater financial and other resources than the Company.

The Company believes that competition for plastic injection molding, contract electronic manufacturing and metal molds and parts manufacturing businesses are based on price, quality, service and the ability to deliver products in a timely and reliable basis. The Company believes that it competes favorably in each of these areas in each business segment.

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 17B and 17E, Edificio Comercial Rodrigues, 599 Avenida da Praia Grande, Macao from an unaffiliated party for a term of two years to July 2005. The premises are used as trading, administrative and accounting office for the Company s plastic injection business. The monthly rent is approximately $2,000.

The Company also leases Unit 6B, Edificio Comercial Rodrigues, 599 Avenida da Praia Grande, Macao from an unaffiliated party for a term of two years to February 2006. The premise is used as trading, administrative and accounting office for the Company s electronic & metallic business. The monthly rent is approximately $820.

Hong Kong

The Company owns Unit 10-14, 19/F., Kwong Sang Hong Centre, 151-153 Hoi Bun Road, Kwun Tong, Hong Kong. This property has been vacant since July 2002 and is leased to an unaffiliated party for a term of three years to October 2006.

Southern China

In October 2000, the Company acquired under sale and purchase agreement with third party an aggregate of approximately 112,900 square feet of manufacturing space at Block G, Wing Village Industrial Estate, Shekou, Shenzhen, China which was previously leased by the Company for the use of its plastic injection molding operations. Deswell paid approximately $1,461,000 to acquire this property.

At March 31, 2005 the Company leased approximately 198,000 square feet of manufacturing space at Block A, 1/F-2/F, Block B, 1/F-3/F, Block D, 1/F-5/F, and Block F, 1/F-5/F Wing Village Industrial Estate, Shekou, Shenzhen, China which are used for its plastic injection molding operations. These factory premises are leased from the local Chinese government and third parties under separate leases expiring from December 2005 to December 2007. The aggregate monthly rent is approximately $47,600.

In January 2000, the Company acquired under sale and purchase agreement with the local government party an aggregate of approximately 1.3 million square feet of land to construct its own manufacturing plant and dormitory buildings in Houjie, Dongguan, China. As at March 31, 2005, there were built and operational 693,000 square feet of factory space, 91,000 square feet of amenity space and 452,000 square feet of dormitory space.

The Company leases space at various locations near its plastics manufacturing factories in Shekou and Dongguan that it uses as dormitories for factory staff and workers. Management estimates that the space leased for dormitories approximated 71,200 square feet and 4,500 square feet at March 31, 2005 in Shekou and Dongguan, respectively. The facilities are leased for periods of one to two years, expiring from April 2005 to January 2006. The aggregate monthly rental is approximately $12,500. The Company has acquired under purchase and sale agreements with third parties an aggregate of approximately 24,600 square feet of additional space at various locations near its plastics manufacturing operations in Shenzhen, which are also used as dormitories for factory staff and workers.

In July 2003, the Company completed the acquisition 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 Cheung On, Dongguan, China, which was previously named Kwan Hong Building. This property was previously leased by the Company for the use in its contract electronic and metal manufacturing operations. The land use period is for 50 years from February 1, 2003 to January 31, 2053. The Company paid approximately $4,186,000 to acquire this property.

At March 31, 2005, the Company leased approximately 69,400 square feet of manufacturing space in Kwanta Building, Cheung On, Dongguan, China for its contract metal manufacturing operation. These premises are leased from third party expiring in May 2007. The aggregate monthly rental is approximately $8,600.

In addition, the Company leases approximately 38,600 square feet of space at various locations near its contract electronics and metal manufacturing factories in Dongguan, Shenzhen, which are used as staff quarters. The facilities are leased from third parties for periods of one to two years and expire from July 2005 to November 2006. The aggregate monthly rental is approximately $7,000.

Management believes that Deswell will be able to renew each of the leases described above as it expires for periods comparable to the current term or find alternative space as needed.

The Company believes that its existing offices and manufacturing space, together with the additional manufacturing space in our Dongguan plant to be completed by end of this year 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.

23

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 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 . This section should be read in conjunction with the Company s Consolidated Financial Statements included under Item 18 of this Report.

Operating Results

The following discussion should be read in conjunction with the consolidated financial statements and notes thereto included later in 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. JIMCO, Jetcrown Shenzhen and Jetcrown Dongguan (wholly owned subsidiaries) carry on the plastics operations whereas Integrated carries out the electronics operations. The Company acquired a controlling interest in Integrated s predecessor in October 1992 and has included the results of the predecessor in its consolidated financial statements from the date of acquisition. Through December 2002, the Company owned a 51% interest in Integrated. In January 2003, the Company increased its interest in Integrated to 71% by purchasing an additional 20% from its minority shareholders in exchange for the issuance to them of an aggregate of 251,880 common shares. In April 2005, the Company increased its interest in Integrated to 76% by purchasing an additional 5% from a minority shareholder in exchange for the issuance to it of 120,000 common shares.

The Company s plastics operations are the mainstay of its business and have historically accounted for the majority of its sales. The Company carries out all of its manufacturing operations in Southern China, where it is able to take advantage of the lower overhead costs and inexpensive 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 manage easily its manufacturing operations from Hong Kong, facilitates transportation of its products through Hong Kong and provides the Company s plastic manufacturing operations with access to electricity from Hong Kong and to nearby water, both of which resources are needed in abundance to manufacture plastic parts and are often inadequate elsewhere in China.

The Company s earnings have benefited from favorable overall effective income tax rates of 24.9%, 3.4% and 3.2% for the years ended March 31, 2003, 2004 and 2005, respectively. The Company is subject to Hong Kong income tax on its income arising in, or derived from, Hong Kong. For information relating to the Company s settlement of a tax dispute with the Hong Kong Inland Revenue Department, or IRD, in 2003 regarding whether Deswell should be assessed additional taxes on profits derived from activities of certain of its subsidiaries during the six fiscal years ended March 31, 2003, see the discussion under Year ended March 31, 2004 Compared to Year Ended March 31, 2003, below. For information regarding Chinese governmental economic, fiscal, monetary or political policies or factors have affected or could materially affect Deswell s operations and investments, please see Item 3. Key Information Risk Factors We Face Numerous Risks as a Result of Our Operations in China And Hong Kong.

Currently, under the Chinese tax system Deswell can obtain tax breaks by reinvesting profits of certain of our subsidiaries in China. For information on our income taxes, rates and concessions with respect to our Chinese operations, see Note 8 of Notes to Financial Statements. The Company expects to continue to benefit from a low overall effective income tax rate in the future, barring unforeseen changes in tax laws and regulations in the various jurisdictions in which it operates. See Uncertain applications of Chinese tax laws could subject us to greater taxes in China included under We face numerous risks as a result of our operations in China and Hong Kong in Item 3. Key Information Risk Factors.

Deswell s material operations are generally organized in three segments: plastic injection molding, or the

24

plastic segment, electronic products assembling and metallic parts manufacturing. Results from Company s metallic parts manufacturing operations have not been material to the Company s operations as a whole and have therefore been combined as the electronic and metallic segment for the table presentation and discussion below. The Company s reportable segments are strategic business units that offer different products and services. The following table sets forth present selected consolidated financial information stated as a percentages of net sales for each of the three years in the period ended March 31, 2005.

	Year ended March 31, 2003			Year ended March 31, 2004			Year ended March 31, 2005		
	Plastic Injection-Molding Segment	Electronic & Metallic Segment	Total	Plastic Injection-Molding Segment	Electronic & Metallic Segment	Total	Plastic Injection-Molding Segment	Electronic & Metallic Segment	Total
Net sales	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Cost of sales	57.0	79.4	67.1	60.4	77.2	68.0	65.2	80.6	73.3
Gross profit	43.0	20.6	32.9	39.6	22.8	32.0	34.8	19.4	26.7
Selling, general and administrative expenses	19.1	14.1	16.9	18.5	11.1	15.2	16.6	8.9	12.6
Operating income	23.9	6.5	16.0	21.1	11.7	16.8	18.2	10.5	14.1
Interest expense									
Other income, net	1.6		0.9	1.0	0.9	0.9	0.2	0.3	0.3
Income before income taxes and minority interest	25.5	6.5	16.9	22.1	12.6	17.8	18.4	10.8	14.4
Income taxes	4.1	4.3	4.2	0.5	0.8	0.6	0.3	0.6	0.5
Income before minority interests	21.4	2.2	12.7	21.6	11.8	17.2	18.1	10.2	13.9
Minority interests	0.8	2.1	1.4	0.9	3.4	2.0	0.7	2.9	1.8
Net income	20.6%	0.1%	11.3%	20.7%	8.4%	15.1%	17.4%	7.3%	12.1%

Year ended March 31, 2005 Compared to Year Ended March 31, 2004

Net Sales - The Company s net sales for the year ended March 31, 2005, were $125,590,000, an increase of $28,395,000 or 29.2% as compared to year ended March 31, 2004. Sales to Digidesign Inc. (Digidesign), Epson Precision (H.K.) Ltd. (Epson), Line 6 Manufacturing and VTech Telecommunications Ltd. (VTech), the Company s four largest customers during the year ended March 31, 2005, represented approximately 64.6% of net sales for the year. See Item 4 Information on the Company Major Customers .

The increase in sales was mainly related to the increase in sales of plastic segment of $6,596,000 and the increase in sales of electronic and metallic segment of $21,799,000. This represented an increase of 12.4% and 49.4%, respectively, as compared with the respective net sales from these segments in the prior year.

The revenue increase in the plastics segment was mainly a result of increase in orders from its existing and new customers of $5,461,000 and $1,135,000, respectively, as compared to the corresponding period last year. The increase in net sales in the electronic and metallic segment was mainly due to an increase in orders from both existing and new customers of $21,041,000 and $1,950,000, respectively, offsetting the net decrease in orders from old customers of $1,192,000 during the year ended March 31, 2005. The net increase resulted from a change in the customer mix during the period as compared with last year.

Gross Profit - The overall gross profit for the year ended March 31, 2005 was $33,518,000, representing an overall gross profit margin of 26.7%. This compares with the overall gross profit and gross profit margin of $31,090,000 or 32.0% for the year ended March 31, 2004.

Gross profit in plastic segment decreased by $266,000, to $20,752,000 or 34.8% of net sales, for the fiscal year ended March 31, 2005, compared to $21,018,000 or 39.6% of net sales for fiscal 2004. This was mainly attributed to an average 20% to 30% increase in resin cost and the increase in net sales of relatively lower margin plastic injection assemblies over the fiscal year 2005, and therefore offsetting the increase in net sales for the year.

Gross profit in the electronic & metallic segment increased by $2,694,000, to $12,766,000 or 19.4% of net sales, for fiscal year ended March 31, 2005 compared to $10,072,000 or 22.8% of net sales, for fiscal 2004. This was mainly attributed to the change in sales mix and the increased demand for lower margin products over the corresponding year. There was also an increase in electronic material cost which could not be added to the selling price to customers. In addition, Deswell s electronic division was more proactive in fiscal 2005 in offering volume pricing for large orders than it was in fiscal 2004.

Selling, general and administrative expenses SG&A expenses for the year ended March 31, 2005 were $15,759,000, amounting to 12.5% of total net sales, as compared to $14,718,000 or 15.1% of total net sales for the year ended March 31, 2004.

The SG&A expenses in the plastic segment increased by $86,000 or 0.9%, to $9,890,000 or 16.6% of net sales, for the year ended March 31, 2005 compared to $9,804,000 or 18.5% of net sales, for fiscal 2004.

The SG&A expenses in the electronic and metallic segment increased by $955,000 or 19.4%, to $5,869,000 or 8.9% of net sales, for the year ended March 31, 2005, compared to $4,914,000 or 11.1% of net sales for fiscal 2004. The increase was primarily related to the increase in salary expenses of $542,000, other general administration expenses of $350,000 and selling expenses of $218,000, offsetting a decrease in depreciation expenses of $159,000 during the year ended March 31, 2005.

Operating income Operating income was $17,759,000 for the year ended March 31, 2005, an increase of $1,387,000 or 8.5% as compared with the prior year.

On a segment basis, the operating income of plastic segment decreased $352,000 to $10,862,000 or 18.2% of net sales, in fiscal 2005 compared to $11,214,000 or 21.1% of net sales in fiscal 2004. The decrease in operating income was due to the decrease in gross profit together with the increase in SG&A expenses.

The operating income of electronic and metallic segment increased $1,739,000 to $6,897,000 or 10.5% of net sales, in fiscal 2005 compared to $5,158,000 or 11.7% of net sales in fiscal 2004. The increase in operating income is attributable to the increase in net sales and gross profit, despite the increase in SG&A expenses described above.

Other income Other income was $342,000 for the year ended March 31, 2005, a decrease of $568,000 or 62.4% as compared with the prior year. On a segment basis, other income attributable to the plastic segment decreased $397,000 to $105,000 in fiscal 2005. This decrease in other income was primarily attributable to the decrease in interest income of $103,000 and the decrease in net realized gain on disposal of investment securities of $533,000, which offset the decrease in loss on disposal of fixed assets of $269,000 during the year.

Other income attributable to the electronic and metallic segment decreased $171,000, to $237,000 in fiscal 2005. This decrease in other income was primarily attributable to the unrealized loss on revaluation of marketable securities of $53,000, a decrease in rental income of $102,000, a decrease in exchange gain of $92,000 and a decrease in compensation and rework charges of $209,000, which offset a realized gain on disposal of other investments of $295,000 during the year.

Income Taxes - Income tax expense was $576,000 for the year ended March 31, 2005, compared to $589,000 for the prior year.

On a segment basis, the income taxes of plastic segment decreased $51,000 to $202,000 for the year ended March 31, 2005 whereas the income tax expenses for the electronic and metallic segment increased $38,000 to $374,000 for the year ended March 31, 2005, respectively. The decrease in the plastic segment was primarily due to the increase in net sales in a subsidiary that still benefited from a tax exemption holiday period during the year ended March 31, 2005 whereas the increase in the electronic and metallic segment was due to the increase in net sales during the fiscal year 2005 despite the tax exemption we receive since we relocated our trading operations to Macao in

June 2004.

Minority Interest Minority interests represent a 29% minority interest in Integrated International Limited, the holding company holding the capital stock of Deswell s electronic and metallic subsidiaries and a 49% minority interest in the subsidiary conducting marketing for Deswell s plastic and electronic businesses. In January 2003, the Company acquired an additional 20% interest in Integrated, increasing its ownership in that subsidiary from 51% to 71%. In January 2005, the marketing subsidiary ceased operations and has been dormant since then. Despite the

Table of Contents

decrease in minority interest in Deswell s electronic and metallic segment, the dollar amount of minority interest increased to $2,330,000 for the year ended March 31, 2005, from $1,957,000 in the prior year, which reflects that the electronics and metallic subsidiary generated more net income in the quarter ended March 31, 2005, compared with corresponding quarter in fiscal 2004.

Net Income - Net income was $15,183,000 for the year ended March 31, 2005, an increase of $463,000 or 3.6%, as compared to the year ended March 31, 2004, and net income as a percentage of net sales decreased to 12.1% from 15.1%.

Net income for the plastic segment decreased by 5.7% to $10,374,000 for fiscal 2005 compared to $10,996,000 for fiscal 2004. The decrease in net income of the plastic segment was mainly the result of the decrease in operating income and other income offsetting the decrease in tax expenses described above.

Net income for the electronic and metallic segment increased $1,085,000 or 29.1% to $4,809,000 for fiscal 2005 compared to $3,724,000 for fiscal 2004. The increase in net income of the electronic and metallic segment was mainly the result of the increase in operating income offsetting the decrease in other income, the increase in income tax expenses and minority interest as described above.

Year ended March 31, 2004 Compared to Year Ended March 31, 2003

Net Sales - The Company s net sales for the year ended March 31, 2004, were $97,195,000, an increase of $6,290,000 or 6.9% as compared to year ended March 31, 2003. Sales to Digidesign, VTech, Epson and Inter-Tel Incorporated , the Company s four largest customers during the year ended March 31, 2004, represented approximately 61.1% of net sales for the year.

The increase in sales during the year ended March 31, 2004 was mainly related to the increase in sales of plastic segment of $3,139,000 and the increase in sales of electronic and metallic segment of $3,151,000. This represented an increase of 6.3% and 7.7%, respectively, as compared with the respective net sales from these segments in the prior year.

The increase in net sales in the plastic segment was mainly due to an increase in orders from existing customers by $831,000, coupled with orders from new customers of $2,308,000 during the year. The increase in net sales in the electronic and metallic segment was mainly due to an increase in orders from new customers of $5,116,000 offsetting the net decrease in orders from existing customers of $1,965,000 during the year. The net increase resulted from a change in customer mix during the year. The increase in sales from new customers included $4,459,000 in sales of professional audio equipment products.

Net sales to customers by geographic area are determined by reference to shipping destinations as directed by the Company s customers. During the year ended March 31, 2004, sales to North America and other areas increased by $11,410,000 and $597,000, respectively, and sales to China, Hong Kong and Europe decreased by $3,408,000, $652,000 and $1,657,000, respectively, over levels for the year ended March 31, 2003.

Gross Profit - The gross profit for the year ended March 31, 2004 was $31,090,000, representing a gross profit margin of 32.0%. This compares with the overall gross profit and gross profit margin of $29,899,000 or 32.9% for the year ended March 31, 2003.

Gross profit in plastic segment decreased by $445,000, to $21,018,000 or 39.6% of net sales, for fiscal year ended March 31, 2004 compared to $21,463,000 or 43% of net sales for fiscal 2003. This was mainly attributed to an average of 20% increase in plastic resin costs, which we could not pass on to our customers, and the increase in net sales of relatively lower margin plastic injection assembly products over levels during fiscal year 2004, thereby offsetting increases in net sales for the year as described above.

Gross profit in the electronic and metallic segment increased by $1,636,000 to $10,072,000 or 22.8% of net sales, for fiscal year ended March 31, 2004 compared to $8,436,000 or 20.6% of net sales, for fiscal 2003. This was mainly attributable to the result of focusing on higher margin sales which could be seen in the change in customer mix as described above, the reduction of factory rental expenses of $539,000 as a result of the purchase of the factory premises in July 2003, and the increase in orders from new customers over the year as described above.

Table of Contents

Selling, general and administrative expenses SG&A expenses for the year ended March 31, 2004 were $14,718,000, amounting to 15.1% of total net sales, as compared to $15,354,000 or 16.9% of total net sales for the year ended March 31, 2003.

SG&A expenses in the plastic segment increased by $247,000 or 2.6%, to $9,804,000 or 18.5% of net sales, for the year ended March 31, 2004 compared to $9,557,000 or 19.1% of net sales, for fiscal 2003. SG&A expenses in the electronic and metallic segment decreased by $883,000 or 15.2%, to $4,914,000 or 11.1% of net sales, for the year ended March 31, 2004 compared to $5,797,000 or 14.1% of net sales for fiscal 2003. The decrease was primarily related to the decrease in salary expenses as a result of the write back of a $231,000 bonus provision and the reduction in a provision for tax risk expenses of $315,000, coupled with the imposition of cost reduction controls during the year in the electronic and metallic segment.

Operating income Operating income was $16,372,000 for the year ended March 31, 2004, an increase of $1,827,000 or 12.6% as compared with the prior year. On a segment basis, the operating income of plastic segment decreased $692,000 to $11,214,000 or 21.1% of net sales, in fiscal 2004 compared to $11,906,000 or 23.9% of net sales in fiscal 2003. The decrease in operating income was attributable to the decrease in gross profit coupled with the increase in SG&A expenses as described above.

The operating income of electronic and metallic segment increased $2,519,000 to $5,158,000 or 11.7% of net sales, in fiscal 2004 compared to $2,639,000 or 6.4% of net sales in fiscal 2003. The increase in operating income was attributable to the increase in gross profit and the decrease in SG&A expenses as described above.

Other income Other income was $910,000 for the year ended March 31, 2004, an increase of $92,000 or 11.1% as compared with the prior year. On a segment basis, other income attributable to the plastic segment decreased $279,000 to $502,000 in fiscal 2004. This decrease in other income was primarily attributable to the decrease in interest income of $166,000 and the decrease in exchange gain of $600,000, which offset the net realized gain on disposal of investment securities of $533,000 during the year.

Other income attributable to the electronic and metallic segment increased $371,000, to $408,000 in fiscal 2004. This increase in other income was primarily attributable to the increase in compensation and rework charge of $225,000, increase in scrap sales of $40,000, the write back of a payable provision of $46,000 coupled with the decrease in exchange loss of $75,000.

Income Taxes - During 2003, the Company engaged in discussions with the Hong Kong Inland Revenue Department, or IRD, regarding whether Deswell should be assessed taxes on profits derived from activities of certain of its subsidiaries during the six fiscal years ended March 31, 2002, which the Company believed were conducted outside of Hong Kong and were not subject to a profits tax under the Hong Kong Revenue Ordinance. While, based on consultations with Hong Kong tax experts, Deswell believed that its tax position for these years was sound and supportable, management nevertheless concluded that it would be in the Company s best interest to reach an immediate resolution of the tax issue with the IRD in order to avoid the expenditure of substantial time, effort and expense involved in proceedings that could extend years. The resolution also limits the assessment of taxes, interest and/or penalties that would be incurred if the Company did not prevail or sought to settle the dispute later. Accordingly, in June 2003 the Company made a proposal to settle the entire tax dispute and in July 2003, the IRD accepted the proposal. As a result, a provision of $3,532,000 was charged to the Company s consolidated income statements for the three months and year ended March 31, 2003. Of the tax provision of $3,532,000, $2,085,000 was related to the plastic segment and $1,447,000 was related to the electronics and metallic segment. The tax payment was made in the year ended March 31, 2004.

Income tax expense was $589,000 for the year ended March 31, 2004, compared to $3,826,000 for the prior year. The decrease was primarily the result of the above resolution.

Minority Interest Minority interests represent a 29% minority interest in Integrated International Limited, the holding company holding the capital stock of Deswell s electronic and metallic subsidiaries and a 49% minority interest in the subsidiary conducting marketing for Deswell s plastic and electronic businesses. In January 2003, the Company acquired an additional 20% interest in Integrated, increasing its ownership in that subsidiary from 51% to 71%. Despite the decrease in minority interest in Deswell s electronic and metallic segment, the dollar amount of

Table of Contents

minority interest increased to $1,957,000 for the year ended March 31, 2004, from $1,288,000 for the year ended March 31, 2003, which reflects that both the electronics and metallic subsidiaries and marketing subsidiary generated more net income in the fiscal 2004 as compared to fiscal 2003.

Net Income - Net income was $14,720,000 for the year ended March 31, 2004, an increase of $4,477,000 or 43.7%, as compared to the year ended March 31, 2003, and net income as a percentage of net sales increased to 15.1% from 11.3%. The increase in net income for fiscal 2004 was primarily the result of the tax provision of $3.5 million made in fiscal 2003 and settled in July 2003 of the tax dispute with the IRD.

Net income for the plastic segment increased by 7.6% to $10,996,000 for fiscal 2004 compared to $10,223,000 for fiscal 2003. The increase in net income of the plastic segment was mainly the result of the decrease in income taxes $1,799,000, offsetting the decrease in operating profit and the decrease in other income as described above.

Net income for the electronic and metallic segment increased substantially to $3,724,000 for fiscal 2004 compared to $20,000 for fiscal 2003. The increase in net income of the electronic and metallic segment was mainly the result of the decrease in income taxes of $1,438,000, increase in gross profit, decrease in SG&A expenses and the decrease in Deswell s minority interest in Integrated, as described above.

Seasonality

The following table sets forth certain unaudited quarterly financial information for the twelve quarters in the three-year period ended March 31, 2005 (in thousands):

	Year ended March 31,											
	2003				2004				2005			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Net sales	$ 23,305	$ 22,603	$ 25,272	$ 19,725	$ 26,075	$ 25,079	$ 24,784	$ 21,257	$ 28,788	$ 31,924	$ 36,185	$ 28,693
Gross profit	7,447	7,733	8,473	6,246	8,411	7,980	8,401	6,298	8,318	8,461	9,402	7,337
Operating income	3,532	3,665	4,583	2,765	4,646	4,511	4,403	2,812	4,812	4,499	4,837	3,611
Net income	3,691	3,672	3,787	(907)	4,354	4,121	3,535	2,710	3,995	3,628	4,207	3,353

The first calendar quarter (the fourth quarter of the 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. The Company does not experience any other significant seasonal fluctuations.

Impact of Inflation

The Company believes that inflation has not had a material effect on its business. Although the Company has found it difficult to increase the prices of its products in order to keep pace with inflation, particularly in its plastics operations, the Company believes that the location of its manufacturing operations in Southern China has resulted in a lower cost base which still provides it with a competitive advantage. Accordingly, the Company is reliant upon increasing its transaction volume in order to compensate for the effects of inflation.

Exchange Rates

The Company sells most of its products and pays for most components in either Hong Kong dollars or U.S. dollars. Exchange rate fluctuations have not had a significant impact on the Company s operating results. Labor cost and overhead expenses of the Company s Hong Kong operations and China factories are paid in Hong Kong dollars and renminbi, respectively. The exchange rate of the Hong Kong dollar to the U.S. dollar has been fixed by the Hong Kong government since 1983 at approximately HK$7.80 to $1.00 and accordingly has not represented a currency exchange risk to the U.S. dollars. The Chinese government has announced its intention to maintain this fixed exchange rate, but despite such assurances there has been uncertainty reported in this regard. There can be no assurance that the Chinese government will continue to maintain the present currency exchange mechanism and the Company could face increased currency risks if the current exchange rate mechanism is changed. If the currency exchange mechanism between the Hong Kong dollar and the U.S. dollar is changed, the Company s results of operations and financial condition could be materially adversely affected.

In 1994, China adopted a floating currency system whereby the official exchange rate is equal to the market rate. Since the market and official renminbi rates were unified, the value of the renminbi against the dollar has been essentially stable, with an average rate of 8.28 Yuan per $1.00 during Deswell s fiscal years ended March 31, 2003, 2004 and 2005. The Company believes, because its Chinese operations presently are confined to manufacturing products for export or for customers in China that are controlled by foreign investors and which pay the Company in Hong Kong dollars, that the current economic climate in China should not have a direct adverse impact on the Company s business. However, over the years, and especially in the last several months, there have been reports that the Chinese Government is under economic and political pressure from countries with which it trades to permit its currency to appreciate against the dollar. For example, lawmakers in the United States have threatened to impose high tariffs on Chinese imports if China does not adjust its currency. Any material increase in the value of the Hong Kong dollar or Chinese renminbi relative to the U.S. dollar would increase our expenses when translated to US dollars and could make our products more expensive in global markets, such as the United States and the European Union. Tariffs imposed as a result of China s refusal to adjust its currency would make our products exported to the United State more expensive and could place us at a severe competitive disadvantage.

The Company did not hedge its currency risk during the years ended March 31, 2003, 2004 or 2005 and at March 31, 2005, the Company had no open forward currency contracts. The Company continues to review its hedging strategy and there can be no assurance that hedging techniques implemented by the Company will be successful or will not result in charges to the Company s results of operations.

Liquidity and Capital Resources

For the year ended March 31, 2005, net cash generated from operations totaled $16,425,000, including net income of $15,183,000 and depreciation and amortization of $4,970,000. Accounts receivable and inventories increased by $6,134,000 and $4,962,000, respectively, over levels at March 31, 2004, primarily as a result of increases in sales and the general increase in business activities. Accounts payable increased by $5,281,000 over levels at March 31, 2004, primarily because of the increase materials purchases resulting from the increase in net sales. For the year ended March 31, 2004, net cash generated from operations totaled $15,225,000, including net income of $14,720,000 and depreciation and amortization of $4,402,000.

Net cash used in investing activities amounted to $16,967,000 and $14,078,000 for the years ended March 31, 2005 and 2004, respectively. Capital expenditures during these periods totaled $17,003,000 and $19,862,000, respectively. Acquisition of marketable securities during these periods were nil and $1,056,000, respectively. These were financed by cash generated from operations and the proceeds from sale of marketable securities of $6,410,000 during the year ended March 31, 2004. The capital expenditure primarily related to the construction of our new Dongguan manufacturing plant and acquisition of plant and machinery for the Company s production facilities in China.

Net cash used in financing activities for the years ended March 31, 2005 and 2004 was $1,578,000 and $5,354,000, respectively. Net cash used in financing activities during the year ended March 31, 2005 was primarily to fund the Company s dividend payments to its shareholders of $9,234,000, dividend payments to minority shareholders of subsidiaries of $756,000 netting off the proceeds of $9,092,000 from the exercise of stock options from directors and employees and the increase in restricted cash of $650,000. Net cash used in financing activities during the year ended March 31, 2004 was primarily to fund the Company s dividend payments to its shareholders of $8,569,000, dividend payments to minority shareholders of subsidiaries of $582,000 netting off the proceeds of $1,733,000 from the exercise of stock options from directors and employees and the release of restricted cash of $1,976,000.

As a consequence of the fixed exchange rate between the Hong Kong dollar and the U.S. dollar, interest rates on Hong Kong dollar borrowings are similar to U.S. interest rates. The Hong Kong Prime Rate was increased from 5.0% to 5.25% during the year ended March 31, 2005.

At March 31, 2005, the Company had cash and cash equivalents of $28,073,000 and committed credit facilities of $8,078,000, of which none had been used. The Company also had restricted cash of $1,040,000 and

Table of Contents

leasehold land and buildings of $1,259,000, which were pledged as collateral for those credit facilities. The Company expects that working capital requirements and capital additions will continue to be funded through cash on hand and internally generated funds. The Company s working capital requirements are expected to increase in line with the growth in the Company s business.

The Company had capital commitments for construction of our Dongguan plastic injection-molding manufacturing plant and purchase of plant and machinery of $4,018,000 as of March 31, 2005. The Company expects that internally generated funds will be sufficient to satisfy its cash needs for at least the next 12 months. However, we may choose to obtain debt or equity financing if we believe it appropriate to accelerate the phases of construction of our new factory.

A summary of our contractual obligations and commercial commitments as of March 31, 2005 is as follows:

	(In thousands) Year ending March 31,					
	2006	2007	2008	2009	2010	2011 and thereafter
Contractual obligation						
Long-term bank borrowing	$	$	$	$	$	$
Capital (finance) lease obligations						
Operating lease payments	835	540	283			
Capital expenditures	3,940		67	11		
Purchase obligations	8,695	10	11	6		
Other long-term liabilities						
Total	$ 13,470	$ 550	$ 361	$ 17	$	$