DESWELL INDUSTRIES INC
Form 20-F
July 20, 2012

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

FORM 20-F

(Mark one)

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

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

For the fiscal year ended March 31, 2012

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

For the transition period from __________________ to __________________

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

Date of event requiring this shell company report

For the transition period from __________________ to __________________

Commission File Number: 001-33900

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

British Virgin Island
(Jurisdiction of incorporation or organization)
17B, Edificio Comercial Rodrigues,
599 Avenida da Praia Grande, Macao
Special Administrative Region, PRC
(Address of Principal Executive Offices)

Herman Wong, Chief Financial Officer,
Telephone: 853-28-322096; fax: 853-28-323265
E-mail: hermanwong@jetcrown.net
17B, Edificio Comercial Rodrigues
599 Avenida da Praia Grande, Macao
Special Administrative Region, PRC
(Name, Telephone, E-mail and/or Facsimile number and Address of Company Contact Person)

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

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

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

As of March 31, 2012, there were 16,196,810 common shares of the registrant outstanding.

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

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

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

Indicate by check mark whether the registrant: (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. þ Yes o No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). þ Yes o No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule12b-2 of the Exchange Act. (Check one):

Large accelerated o Accelerated filer o Non-accelerated filer þ

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

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

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

If this is an annual report, indicate by check mark whether the registrant is a shell company (as defined in Rule12b-2 of the Exchange Act). o Yes þ No

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INTRODUCTION

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

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

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

- we, us, our company, our, the Company or Deswell refers to Deswell Industries, Inc. and, in the context of describing our operations, also include our operating subsidiaries;
- shares refer to our common shares, no par value;
- China or PRC refers to the People s Republic of China, excluding Taiwan, Hong Kong and Macao;
- Hong Kong refers to the Hong Kong Special Administrative Region of the People s Republic of China;
- Macao refers to the Macao Special Administrative Region of the People s Republic of China;
- all references to:

º renminbi, RMB or yuan are to the legal currency of China, of which the yuan is the base unit;

º HK dollars or HK$ are to the legal currency of Hong Kong;

º MOP$ are to the legal currency of Macao;

º U.S. dollars, dollars , $ or US$ are to the legal currency of the United States; and

º fiscal year, e.g., fiscal 2012, are to our year ended March 31 of the year(s) indicated.

FINANCIAL STATEMENTS AND CURRENCY PRESENTATION

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

PART I

Item 1. IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISORS

Not applicable.

Item 2. OFFER STATISTICS AND EXPECTED TIMETABLE

Not applicable.

Item 3. KEY INFORMATION

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 Operations Data for each of the three fiscal years in the period ended March 31, 2012, and the Balance Sheet data as of March 31, 2011 and 2012 are derived from our audited Consolidated Financial Statements included in this Report. The Selected Operations Data for the years ended March 31, 2008 and 2009, and the Balance Sheet data as of March 31, 2008, 2009, and 2010 are derived from our audited Consolidated Financial Statements, which are not included in this Report.

Selected Financial Data [1]

Consolidated Statement of Operations Data:	(in thousands except per share and statistical data) Year ended March 31,				
	2008	2009	2010	2011	2012
Net sales	$ 143,806	$ 131,738	$ 81,614	$ 84,022	$ 64,783
Cost of sales	117,373	111,570	68,958	74,474	55,318
Gross profit	26,433	20,168	12,656	9,548	9,465
Selling, general and administrative expenses	19,601	19,291	15,505	13,941	12,273
Other income (expenses), net	1,838	(132)	4,594	(4,435)[2]	639
Operating income (loss)	8,670	745	1,745	(8,828)[2]	(2,169)
Non-operating income, net	521	168	444	1,096	1,190
Income (loss) before income taxes	9,191	913	2,189	(7,732)	(979)
Income taxes	104	(282)	690	382	482
Net income (loss)	9,087	1,195	1,499	(8,114)	(1,461)
Net income attributable to non-controlling interests	228				
Net income (loss) attributable to Deswell Industries, Inc.	8,859	1,195	1,499	(8,114)	(1,461)
Other comprehensive loss:					
Unrealized loss on available-for-sale securities					(746)
Comprehensive income (loss) attributable to Deswell Industries, Inc.	$ 8,859	$ 1,195	$ 1,499	$ (8,114)	$ (2,207)
Net income (loss) per share attributable to Deswell Industries, Inc.[3]:					
Basic:					
Net income (loss) per share[4]	$ 0.57	$ 0.08	$ 0.09	$ (0.50)	$ (0.09)
Weighted average common shares outstanding[4]	15,517	15,791	15,965	16,193	16,197
Diluted:					
Net income (loss) per share[4]	$ 0.57	$ 0.08	$ 0.09	$ (0.50)	$ (0.09)
Weighted average common shares outstanding[4]	15,566	15,805	16,039	16,193	16,207
Statistical Data:					
Gross margin	18.4%	15.3%	15.5%	11.4%	14.6%
Operating margin	6.0%	0.6%	2.1%	–10.5%	–3.3%
Dividends per share	$ 0.61	$ 0.24	$ 0.10	$ 0.10	$ 0.12

Balance Sheet Data:	At March 31,				
	2008	2009	2010	2011	2012
Working capital	$ 54,751	$ 52,605	$ 59,848	$ 59,689	$ 60,933
Total assets	140,407	137,482	134,011	127,159	121,959
Long-term debt, less current portion					
Total debt					
Shareholders equity	121,257	120,307	121,015	111,287	107,689

(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) Other expenses, net and operating loss for the year ended March 31, 2011 include a non-cash impairment charge to property, plant and equipment used in the Company s plastic segment of $4,474,000. See Notes 2 and 7 of Notes to Consolidated Financial Statements included later in this report.

(3) Other comprehensive loss for the year ended March 31, 2012 represented unrealized loss on available-for-sale securities. See Note 4 of Notes to Consolidated Financial Statements included later in this Report.

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

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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:

Historically we have been dependent on a few major customers that accounted for a substantial percentage of our sales. Starting from fiscal 2011, we have been limited to one major customer. Our sales will continue to decline and our financial results will suffer further if orders from our major customer or customer base are ceased, or substantially reduced, or if we cannot develop new customers or increase sales from our existing customers.

Historically, before fiscal 2011, a substantial percentage of our sales were to a small number of major customers that each accounted for more than 10% of our net sales. During the year ended March 31, 2010, our major customers together accounted for 42.0% of our total net sales. In the years ended March 31, 2011 and 2012, however, our sales to 10% or greater customers were limited to VTech Telecommunications Limited, which accounted for 14.6% and 12.6% of net sales, 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 has fluctuated in the past and may fluctuate in future. Substantial decreases in sales to, or the loss of major customers, have adversely impacted our sales and financial performance. For example, N&J Company Ltd. and Digidesign, Inc., our two largest customers in fiscal 2010, accounting for 19.2% and 12.0%, respectively, of our total sales during that year, both reduced the volumes of their orders during the years ended March 31, 2011 and 2012 to less than 10% of our total sales. These reductions in sales to major customers were principal contributing factors to the decreases in our total sales over the last two fiscal years and, coupled with a 2.0% year-over-year decrease in sales to VTech, to our operating and net losses during the year ended March 31, 2012.

We cannot assure you that present or future customers will not cease using us as the source of the injection-molded plastic parts and components we manufacture, for electronic manufacturing services of electrical products and subassemblies or for metallic molds and accessories or significantly change, reduce or delay the amount of products and services ordered from us. Our sales will continue to decline and our financial results will suffer further if orders from our largest customer, VTech, or orders from other substantial customers, cease or are significantly reduced unless we can increase sales from other existing customers or add sales from new customers.

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

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

the demand for our customers   products,

the amount, timing and stability of their orders to us,

the financial strength of our customers and suppliers,

our customers   and suppliers   ability or willingness to do business with us,

our suppliers   and customers   ability to fulfill their obligations to us,

the ability of our customers, our suppliers or us to obtain credit, secure funds or raise capital, or

the prices at which we can sell our products and services,

which, in turn, could adversely affect

our ability to manage inventory levels effectively or collect receivables,

our cash flow position,

our net sales, gross margins and operating results; or

otherwise adversely impact our results of operations, financial condition and liquidity.

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

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

Gross Margins Percentage

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

our cost of raw materials, especially our cost of electronic components due to changes in the prices, availability and long lead time of components and parts needed for the manufacturing of electronic products;

costs of labor, particularly in recent years, when such costs have increased substantially as a consequence of increasing governmental regulation directed at labor practices and policies;

the appreciation of the exchange rate of the RMB, in which we pay our labor and manufacturing costs, against the U.S. dollar, in which we present our financial statements;

changes in our customer mix or the mix of higher and lower margin products, or a combination of both in any year;

price increases for products which, for competitive reasons, we choose to allow as concessions in an effort to maintain our customer base;

increases in value-added taxes as result of changes in the value-added tax policy of the Chinese government for various categories of export products; and

increased costs to conform our products to consumer and product safety laws and regulations of the various countries in which our products are sold.

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

If the United States Internal Revenue Service does not agree with our determination regarding our PFIC status under US income tax laws and seeks to treat us as a PFIC, US holders of our shares could be subject to potentially adverse tax consequences.

We believe that we were not a passive foreign investment company, or PFIC, for our fiscal year ended on March 31, 2012. No assurance can be given, however, that the IRS would agree with us and seek to treat us as a PFIC. If we were or are a PFIC U.S. holders of our shares would be subject to potentially adverse tax consequences, as described under United States Federal Income Tax Passive Foreign Investment Company (PFIC) in ITEM 10 Additional Information beginning on page 50 of this Report.

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

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

The consumer price index (CPI), a major gauge of China s inflation rose 4.5 % and food prices jumped 10.5% in January 2012 from levels in January 2011. The central government of China has been encouraging wage hikes in the hope of boosting consumer spending and reducing the economy s reliance on exports.

There is no fixed minimum wage which is applicable to all of China; local governments in China adopt different amounts based on the situation in their area. Effective May 1, 2010, China s Guangdong Province, where our manufacturing facilities are located, raised minimum wages by approximately 20% and effective March 1, 2011 again increased the minimum wage by another approximately 20%. Increases in wages also result in increases in our and other employer s contributions for various mandatory social welfare benefits for Chinese employees that are based on percentages of their salaries. The 2010 and 2011 increases in minimum wages directly affected our cost of labor, increasing our overall operating expenses and adversely affecting our financial results for our years ended March 31, 2011 and 2012.

The Chinese government has recently announced a new plan to increase the average growth rate of China s minimum wage levels to over 13% annually between 2011 and 2015. Continuing material increases in our cost of labor will continue to increase our operating costs and will adversely affect our financial results unless we pass on such increases to our customers by increasing the prices of our products and services. The effect of increases in the prices of our products and services would make our products more expensive in global markets, such as the United States and the European Union. This could result in the loss of customers, who may seek, and be able to obtain, products and services comparable to those we offer in lower-cost regions of the world. If we do not increase our prices to pass on the effect of increases in our labor costs, our margins and financial results would suffer.

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

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

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

The Hong Kong dollar has been pegged to the U.S. dollar at approximately 7.80 and relatively stable. The midpoint exchange rates between the Hong Kong dollar and the U.S. dollar were approximately 7.764, 7.789 and 7.764 at March 31, 2010, 2011 and 2012, respectively, as reported by Historical Exchange Rates at http://www.oanda.com/currency/historical-rates/. The Hong Kong government may not continue to maintain the present currency exchange mechanism, which fixes the Hong Kong dollar at approximately 7.80 to each United States dollar and has not in the past presented a material currency exchange risk. Although announcements by Hong Kong s central bank indicate its intention to maintain the currency peg between the Hong Kong dollar and the U.S. dollar, if Hong Kong does change and follows China to a floating currency system or otherwise changes the

exchange rate system of Hong Kong dollars to U.S. dollars, our margins and financial results could be adversely affected.

Between 1994 and July 2005, the market and official RMB rates were unified and the value of the RMB was essentially pegged to the U.S. dollar and was relatively stable. On July 21, 2005, the People s Bank of China adjusted the exchange rate of RMB to the U.S. dollar by linking the RMB to a basket of currencies and simultaneously setting the exchange rate of RMB to U.S. dollars, from 1:8.27, to a narrow band of around 1:8.11. The chart below illustrates the fluctuations since the July 31, 2005 adjustment of the RMB to the US dollar by showing the exchange ratio at the end of each of Deswell s fiscal years from March 31, 2006 to March 31, 2012.

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

The appreciation and depreciation in the exchange ratio of the RMB to the US dollar increases and decreases, respectively, our costs and expenses to the extent paid in RMB. Approximately 51.0%, 47.0% and 49.0% of our total costs and expenses were in RMB during the years ended March 31, 2010, 2011 and 2012, respectively.

The following table shows the percentage appreciation in the exchange rate of the RMB to the US dollar at the end of each of our fiscal years in the three-year period ended March 31, 2012:

Exchange ratio of RMB to US$1.00 at March 31,(1)

2010		2011		2012	
Ratio	**% change(2)**	**Ratio**	**% change(2)**	**Ratio**	**% change(2)**
1:6.826	0.14%	1:6.560	3.90%	1:6.319	3.68%

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

(2) From ratio at previous March 31.

In mid-2008, the Chinese government halted allowing the RMB to appreciate against the dollar as it did during earlier periods since July 25, 2005 because of concerns that the stronger RMB was hurting Chinese exports at a time of global recession. Accordingly, as shown in the above table, there was virtually no change in the exchange ratio of the RMB to the U.S. dollar during our year ended March 31, 2010. However, on June 19, 2010 China s central bank announced that it planned to introduce more flexibility in the management of its currency and since

then the RMB again began to appreciate against the U.S. dollar, increasing 3.9% at March 31, 2011 from the midpoint level at March 31, 2010, and increasing an additional approximately 3.7% at March 31, 2012 from the midpoint level at March 31, 2011, as reported by Historical Exchange Rates at http://www.oanda.com/currency/historical-rates/.

There remains significant international pressure on the PRC government to adopt an even more flexible currency policy, which, if adopted, could result in appreciation of the exchange rate of the RMB to the U.S. dollar beyond the appreciation experienced under China s current system.

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

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

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

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

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

We manufacture and sell injection-molded plastic parts and components and provide manufacturing services for electrical products and subassemblies to companies and industries that have in the past, and may in the future, experience financial difficulty, particularly in light of recent conditions in the credit markets and the overall worldwide economy. For information on the concentration of our credit risk, see Note 15 of Notes to Consolidated Financial Statements included later in this Report.

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

- provision or increased provision for doubtful accounts,
- a charge for inventory write-offs,
- a reduction in revenue,

decreases in cash, and

increases in working capital requirements.

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

At March 31, 2012, we had cash on hand of $33.1 million and time deposits maturing over three months of $4 million, which were invested in short-term interest bearing investments at banks or other financial institutions. Of that amount, approximately $11.1 million was held in banks and other financial institutions in Hong Kong, $10.3 million in Macao and $15.7 million in the PRC. The Hong Kong government provides deposit protection up to a maximum amount of HK$500,000 (approximately US$64,400 based on the midpoint exchange rate for March 31, 2012 reported by Historical Exchange Rates at http:// www.oanda.com/currency/ historical-rates/) for each depositor in any individual bank in Hong Kong, and the Macao government provides deposit protection up to a maximum amount of MOP$500,000 (approximately US$62,500 based on the midpoint exchange rate for March 31, 2012 reported by Historical Exchange Rates at http:// www.oanda.com/currency/ historical-rates/) for each depositor with any individual bank in Macao. We understand that in the event of a bank failure of a bank in the PRC, a PRC-government agency is to provide some, unspecified, protections of deposit accounts to individual depositors. After three interest rate hikes in 2011, there were recommendations in early 2012 from China s economists that a formal insurance system from China s central bank is necessary to protect depositors assets. However, we are not aware of the amount or limit of deposit protection that may be provided by the PRC government. Depending upon the amounts of funds we have on deposit in a Hong Kong, Macao or PRC financial institution that fails, our inability to have immediate access to our cash, and the lack of deposit protection in excess of applicable protection limits, could impair our operations, and, if we are not able to access needed funds to pay our suppliers, employees and other creditors, we may be unable to continue in business.

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

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

Uncertainty and adverse changes in the economy and financial markets may also increase the competitive environment in our market segments which could also impact our operating results. In addition, the EMS industry is currently experiencing excess manufacturing capacity and has seen increased competition. These factors have exerted and will continue to exert additional pressures on pricing for injection-molded plastic parts and components and for our electronic manufacturing services, thereby increasing the competitive pressures in our market segments generally. We may not be able to compete successfully against our current and future competitors, and the competitive pressures we face may have a material adverse effect on us.

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

The primary materials used by us in the manufacture of our plastic injection molded products are various plastic resins. The following table shows our cost of plastic resins as a percentage of our cost of plastic products sold and as a percentage of our total costs of goods sold for the years ended March 31, 2010, 2011 and 2012:

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

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

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

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

We face inventory risks from by providing turnkey manufacturing of electronic products.

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

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

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

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

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

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

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

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

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

Risks associated with our business include risk of damage to our stock in trade, goods and merchandise, furniture and equipment and factory buildings in China. At March 31, 2012, we maintained fire, casualty and theft insurance aggregating approximately $85.4 million covering damages to fixed and movable assets, equipment, manufacturing facilities in China and furniture and fixtures at our facilities. The proceeds of this insurance may not be sufficient to cover material damage to, or the loss of, any of our factories due to fire, severe weather, flood, forces of nature, such as major earthquakes, which are common in China, or other natural disasters. We may experience difficulty or delays in receiving compensation from the insurance companies and may not receive insurance proceeds adequate to compensate us fully for a potential loss. Although we maintain insurance addressing damage to and destruction to our facilities and equipment, we do not have business interruption insurance.

Despite quality assurance measures, there remains a risk that defects may occur in our products. The occurrence of any defects in our products could give rise to liability for damages caused by such defects. They could, moreover, impair the market s acceptance of our products. At March 31, 2012, we had only limited product liability insurance. Although we have not experienced any product quality claims from significant customers, if future claims do arise, costs to defend, adverse judgments or amounts we may be forced to pay in settlement would increase our expenses. If we incur losses which are not covered under our insurance, or the amount of compensation that we receive from the insurer is significantly less than the actual loss, our financial condition and results of operations could be materially and adversely affected.

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

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

Prior to the new unified enterprise income tax (EIT) law which became effective in China on January 1, 2008, PRC-organized companies were exempt from withholding taxes with respect to earnings distributions, or dividends, paid to shareholders of PRC companies outside the PRC, such as the case when our PRC subsidiaries distributed portions of their earnings to our offshore subsidiaries. However, under the new EIT Law, dividends payable to foreign investors which are derived from sources within the PRC are subject to income tax at the rate of 10% by way of withholding unless the foreign investors are companies incorporated in countries which have a tax treaty agreement with PRC and the rate agreed by both parties will be applied. As a result of this PRC withholding tax, amounts available to us in earnings distributions from our PRC enterprises have been reduced. Since we derive the funds distributed to shareholders from our subsidiaries in the PRC, the reduction in amounts available for distribution from our PRC enterprises could, depending on the income generated by our PRC subsidiaries, force us to reduce, or possibly eliminate, the dividends we have paid to our shareholders historically. For this reason, or other factors, we may decide not to declare dividends in the future. If we do pay dividends, we will determine the amounts when they are declared and even if we do declare dividends in the future, we may not continue them in any future period.

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

Under the PRC s EIT Law, an enterprise established outside of China whose de facto management bodies are located in China is considered a resident enterprise and is subject to the 25% enterprise income tax rate on its

worldwide income. The new EIT Law and its implementing rules are relatively new, and currently, no official interpretation or application of this new resident enterprise classification is available. Therefore, it is unclear how tax authorities will determine the tax residency of enterprises established outside of China.

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

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

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

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

Historically, the United States has been the major or significant geographical area of our product sales in terms of shipping destinations. While China has been granted permanent most favored nation trade status in the United States, controversies between the United States and China may arise that threaten the status quo involving trade between the United States and China. These controversies could adversely affect our business by, among other things, causing our products in the United States to become more expensive, which could result in a reduction in the demand for our products by customers in the United States. Political or trade friction between the United States and China, whether or not actually affecting our business, could also adversely affect the prevailing market price of our common shares. This risk has increased in recent years as our sales into the United States have accounted for significant amounts of our global sales, The United States was our number two market in our years ended March 31, 2010 and 2011 and became our number one market in our year ended March 31, 2012. See Item 4 INFORMATION ON THE COMPANY Customers and Marketing on page 28 of this Report for information regarding our net sales as a percentage of total sales to customers by geographic area.

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

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

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

Our administration and accounting 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.

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

In June 2007, the National People s Congress of the PRC enacted labor legislation, called the Labor Contract Law, and that law became effective on January 1, 2008. The law formalized workers rights concerning overtime hours, pensions, layoffs, employment contracts and the role of trade unions. Considered one of the strictest labor laws in the world, among other things, this law requires an employer to conclude an open-ended employment contract with any employee who either has worked for the employer for 10 years or more or has had two consecutive fixed-term contracts. An open-ended employment contract is in effect a lifetime, permanent contract, which is terminable only in specified circumstances, such as a material breach of the employer s rules and regulations, or for a serious dereliction of duty. Such employment contracts with qualifying workers would not be terminable if, for example, we determined to downsize our workforce in the event of an economic downturn. Under the 2007 law, downsizing by 20% or more may occur only under specified circumstances, such as a restructuring undertaken pursuant to China s Enterprise Bankruptcy Law, or where a company suffers serious difficulties in production and/or business operations. Also, if we lay off more than 20 employees or 10% at one time, we have to communicate with the labor union of our Company and report to the District Labor Bureau. Deswell s entire staff, who are employed to work exclusively within the PRC, is covered by the new law. In response to prevailing economic conditions, we reduced our workforce by 150, 930 and 650 during the years ended March 31, 2010, 2011 and 2012, respectively.

We may incur much higher costs under China s Labor Contract Law if we are forced to downsize our workforce in the future. Accordingly, this law can be expected to exacerbate the adverse effect of the unfavorable economic conditions on our results of operations and financial condition.

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

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

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

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

Our strategy has been to evaluate trade names and trademarks, and to consider seeking patents, where we believe that such trade names, trademarks or patents would be available and adequate to protect our rights to

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

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

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

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

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

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

We are incorporated in the British Virgin Islands and have subsidiaries incorporated in the British Virgin Islands, Macao, Samoa and China. Our administrative and accounting office is located in Macao. We manufacture all of our products in China. As of March 31, 2012, approximately 64.5% of the net book value of our total identifiable assets was located in China. We sell our products to customers principally in the United States, China, the United Kingdom, 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 negatively impact our operations in that region, or as a whole.

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

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

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

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

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

Power shortages in China could affect our business.

We consume substantial amounts of electricity in our manufacturing processes at our production facilities in China. Certain parts of China, including areas where our manufacturing facilities are located, have been subject to power shortages in recent years. We have experienced a number of power shortages at our production facilities in China to date. We are sometimes given advance notice of power shortages and in relation to this we currently have a backup power system. However, there can be no assurance that in the future our backup power system will be completely effective in the event of a power shortage, particularly if that power shortage is over a sustained period of time and/or we are not given advance notice of it. Any power shortage, brownout or blackout for a significant period of time may disrupt our manufacturing, and as a result, may have an adverse impact on our business.

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

As of March 31, 2012, our balance sheet included approximately $46.2 million in long-lived assets. Under applicable accounting rules, we review long-lived assets, such as property, plant, and equipment, for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Valuation of our long-lived assets requires us to make various assumptions and these assumptions are used to forecast future, undiscounted cash flows. Given the significant uncertainty and instability of macroeconomic conditions in recent periods, forecasting future business is difficult and subject to modification. If actual market conditions differ or our forecasts change, we may be required to reassess long-lived assets and could record an impairment charge. For example, because of the impact during fiscal 2011 on our injection molded plastics business of the world-wide economic slowdown, we recorded non-cash impairment charges to property, plant and equipment used in that segment of $4.5 million, more than doubling the total operating loss we would have otherwise reported for the year ended March 31, 2011. Any future impairment charges relating to our long-lived assets would have the effect of decreasing our earnings or increasing our losses in such period, as was the case in fiscal 2011. Although we took no impairment charges during our year ended March 31, 2012, if we are required to take substantial impairment

charges in future periods, our operating results could be materially adversely affected in the period or periods in which the charges occur.

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

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

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

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

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

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

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

We prepare our financial statements in conformity with the generally accepted accounting principles of the United States of America US GAAP . A change in these accounting principles and policies, especially as interpreted by the Securities and Exchange Commission and The NASDAQ

Stock Market, may have an impact on our future financial position and results of operations. Historically, regulatory changes, such as the requirement of the Financial Accounting Standards Board to expense stock options grants, and other legislative initiatives have increased our general and administrative costs and future changes could have a similar adverse impact on our financial results.

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

On June 30, 2012, members of our senior management and Board of Directors as a group beneficially owned approximately 22.4% of our outstanding common shares. As a result, acting together, they may be able to control or at least 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.

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 or excluded from certain provisions applicable to United States public companies including:

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

In addition, because we are a foreign private issuer, certain of the corporate governance standards of The NASDAQ Stock Market that are applied to domestic companies having securities included on The NASDAQ Stock Market are not applicable to us. For example, as a foreign private issuer organized under the law of the British Virgin Islands, we may follow our home company practice in lieu of some of the corporate governance provisions of sections 5600 *et. seq*. of NASDAQ s Marketplace Rules. Accordingly, as the law of the British Virgin Islands does not prohibit us from doing so and since our practices are in compliance with our Memorandum and Articles of Association, we follow our home company practices with respect to the following NASDAQ Market Place rules:

- *Rule 5605(b)(2)*: Our independent directors do not meet in executive session;

Rule 5605(d): Our board does not have a compensation committee and compensation of our Chief Executive Officer and other executive officers is neither determined nor recommended to the board by a majority of our independent directors; and

Rule 5605(e): Nominees for appointment as our directors are not selected or recommended by either a majority of our independent directors, or a nominating committee composed solely of independent directors.

Although we may also follow our home company practice in lieu of NASDAQ s Marketplace Rule 5605(b)(1) requiring the independence of a majority of our directors, during the year ended March 31, 2012 to date, the composition of our Board of Director has consisted of a majority of directors deemed independent under that Rule.

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

ITEM 4. INFORMATION ON THE COMPANY

Corporate Information

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

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

The Company s registered agent in the British Virgin Islands is Harneys Corporate Services Limited, P.O. Box 71, Craigmuir Chambers, Road Town, Tortola, British Virgin Islands. The Company s principal administrative office is located in 17B, Edificio Comercial Rodrigues, 599 Avenida da Praia Grande, Macao, and its telephone number is (853) 2832-2096 and its facsimile number is (853) 2832-3265. Our principal manufacturing facilities and operations are currently based in Dongguan, Guangdong, China.

Important Events in Deswell s Development that Have Occurred since April 1, 2011

In March 2012, the Company announced that its board of directors had unanimously approved, a share repurchase program authorizing Deswell s management to purchase up to $4 million of Deswell s outstanding common shares during the next two years. The program does not obligate Deswell to acquire any particular number or dollar amount of its common shares and may be suspended, modified, extended or discontinued at any time. Through March 31, 2012, Deswell did not purchase any of its common shares. No assurance can be given that any particular number or dollar amount of common shares will be repurchased after March 31, 2012.

[Continued on Page 21]

Organizational Structure

The following diagram illustrates the organizational structure of the Company and its active subsidiaries at March 31, 2012.

Capital Expenditures

Principal capital expenditures and divestitures made by Deswell during the three years in the period ended March 31, 2012 included the following (dollar amounts in thousands):

	Year ended March 31,		
	2010	**2011**	**2012**
Purchase of property, plant and equipment	$ 1,606	$ 1,034	$ 281
Proceeds from the sale of property, plant and equipment, net of transaction costs	5,528	87	314

Our major capital expenditures in fiscal 2012 included:

$0.05 million for plant and machinery for plastic and electronic products;

$0.14 million for furniture, fixtures and equipment; and

$0.09 million for leasehold improvements.

Our major capital expenditures in fiscal 2011 included:

$0.6 million for plant and machinery for plastic and electronic products;

$0.3 million for furniture, fixtures and equipment; and

$0.1 million for leasehold improvements.

Our major capital expenditures in fiscal 2010 included:

$0.5 million for land and buildings, and leasehold improvements;

$0.6 million for furniture, fixtures and equipment; and

$0.5 million for motor vehicles.

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.