

STEC, INC.  
Form 10-Q  
May 15, 2007  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**FORM 10-Q**

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

For the quarterly period ended March 31, 2007

or

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 000-31623

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**STEC, INC.**

(Exact name of Registrant as specified in its charter)

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**CALIFORNIA**  
(State or other jurisdiction of  
incorporation or organization)

3001 Daimler Street

**33-0399154**  
(I.R.S. Employer  
Identification No.)

92705-5812

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**Santa Ana, CA**  
(Address of principal executive offices)

**(949) 476-1180**

(Zip Code)

(Registrant's telephone number, including area code)

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

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

Large Accelerated Filer  Accelerated Filer  Non-Accelerated Filer

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

The number of shares outstanding of the registrant's common stock, par value \$0.001, as of April 30, 2007 was 49,858,902.

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**STEC, INC.**

**INDEX TO FORM 10-Q FOR THE  
QUARTERLY PERIOD ENDED MARCH 31, 2007**

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Except as otherwise noted in this report, STEC, the Company, we, us and our collectively refer to STEC, Inc.

**Table of Contents****PART I FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****STEC, INC.****CONSOLIDATED BALANCE SHEETS**

(in thousands, except share and per share amounts)

(unaudited)

|  | March 31,<br>2007 | December 31,<br>2006 |
|--|-------------------|----------------------|
| <b>ASSETS:</b>   |                   |                      |
| Current Assets:  |                   |                      |
| Cash and cash equivalents  | \$ 100,675        | \$ 40,907            |
| Accounts receivable, net of allowances of \$845 at March 31, 2007 and \$1,620 at December 31, 2006   | 26,190            | 34,823               |
| Inventory, net   | 49,058            | 51,453               |
| Deferred income taxes  | 437               | 1,521                |
| Current assets of discontinued operations  |                   | 57,880               |
| Other current assets   | 3,960             | 1,691                |
| <b>Total current assets</b>  | <b>180,320</b>    | <b>188,275</b>       |
| <br>   |                   |                      |
| Furniture, fixtures and equipment, net   | 14,905            | 11,696               |
| Intangible assets  | 1,343             | 1,439                |
| Goodwill   | 1,682             | 1,682                |
| Other long-term assets   | 573               | 423                  |
| Deferred income taxes  | 3,926             | 2,973                |
| Long-term assets of discontinued operations  |                   | 168                  |
| <br>   |                   |                      |
| <b>Total assets</b>  | <b>\$ 202,749</b> | <b>\$ 206,656</b>    |
| <b>LIABILITIES AND SHAREHOLDERS EQUITY:</b>  |                   |                      |
| Current Liabilities:   |                   |                      |
| Accounts payable   | \$ 15,910         | \$ 21,104            |
| Accrued and other liabilities  | 5,540             | 7,111                |
| Liabilities of discontinued operations   |                   | 12,427               |
| <br>   |                   |                      |
| <b>Total liabilities</b>   | <b>21,450</b>     | <b>40,642</b>        |
| <br>   |                   |                      |
| Long-term income taxes payable   | 1,285             |                      |
| <br>   |                   |                      |
| Commitments and contingencies (Note 8)   |                   |                      |
| Shareholders' Equity:  |                   |                      |
| Preferred stock, \$0.001 par value, 20,000,000 shares authorized, no shares outstanding  |                   |                      |
| Common stock, \$0.001 par value, 100,000,000 shares authorized, 49,634,602 shares issued and outstanding as of March 31, 2007 and 48,677,834 shares issued and outstanding as of December 31, 2006 | 50                | 49                   |
| Additional paid-in capital   | 135,716           | 128,353              |
| Retained earnings  | 44,248            | 37,612               |

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|  |            |            |
|--|------------|------------|
| Total shareholders' equity                 | 180,014    | 166,014    |
| Total liabilities and shareholders' equity | \$ 202,749 | \$ 206,656 |

See accompanying notes to unaudited consolidated financial statements.

**Table of Contents****STEC, INC.****CONSOLIDATED STATEMENTS OF INCOME****(in thousands, except per share amounts)****(unaudited)**

|  | <b>Three Months Ended<br/>March 31,</b> |                 |
|--|---|-----------------|
|  | <b>2007</b>                             | <b>2006</b>     |
| Net revenues   | \$ 47,204                               | \$ 40,433       |
| Cost of revenues   | 32,779                                  | 31,264          |
| <b>Gross profit</b>  | <b>14,425</b>                           | <b>9,169</b>    |
| Sales and marketing  | 4,433                                   | 3,008           |
| General and administrative   | 3,833                                   | 2,913           |
| Research and development   | 3,699                                   | 2,020           |
| <b>Total operating expenses</b>  | <b>11,965</b>                           | <b>7,941</b>    |
| Operating income   | 2,460                                   | 1,228           |
| Interest income  | 761                                     | 475             |
| Income from continuing operations before provision for income taxes                        | 3,221                                   | 1,703           |
| Provision for income taxes   | 1,168                                   | 582             |
| Income from continuing operations  | \$ 2,053                                | \$ 1,121        |
| Discontinued operations (Note 3):  |   |                 |
| Income (loss) from operations of Consumer Division (including gain on disposal of \$7,967) | \$ 7,723                                | \$ (133)        |
| Benefit (provision) for income taxes   | (3,066)                                 | 53              |
| Income (loss) on discontinued operations   | \$ 4,657                                | \$ (80)         |
| <b>Net income</b>  | <b>\$ 6,710</b>                         | <b>\$ 1,041</b> |
| Net income per share:  |   |                 |
| Basic:   |   |                 |
| Continuing operations  | \$ 0.04                                 | \$ 0.02         |
| Discontinued operations  | \$ 0.10                                 | \$              |
| Total  | \$ 0.14                                 | \$ 0.02         |
| Diluted:   |   |                 |
| Continuing operations  | \$ 0.04                                 | \$ 0.02         |
| Discontinued operations  | \$ 0.09                                 | \$              |
| Total  | \$ 0.13                                 | \$ 0.02         |
| Shares used in net income per share computation:   |   |                 |
| Basic  | 48,924                                  | 45,149          |

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|         |        |        |
|---------|--------|--------|
| Diluted | 51,696 | 46,207 |
|---------|--------|--------|

See accompanying notes to unaudited consolidated financial statements.

**Table of Contents****STEC, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS****(in thousands)****(unaudited)**

|  | <b>Three Months Ended<br/>March 31,</b> |                  |
|--|---|------------------|
|  | <b>2007</b>                             | <b>2006</b>      |
| Cash flow from operating activities:   |   |                  |
| Income from continuing operations  | \$ 2,053                                | \$ 1,121         |
| Adjustments to reconcile net loss to net cash provided by operating activities:    |   |                  |
| Depreciation and amortization  | 1,045                                   | 961              |
| Gain on sale of furniture, fixtures and equipment                                  | (31)                                    |                  |
| Accounts receivable provisions (benefit)   | (296)                                   | 387              |
| Inventory excess and obsolescence expense  | 855                                     | 134              |
| Deferred income taxes  | 131                                     | (239)            |
| Stock-based compensation expense   | 240                                     |                  |
| Change in operating assets and liabilities:  |   |                  |
| Accounts receivable  | 8,929                                   | (10,713)         |
| Inventory  | 1,540                                   | 1,268            |
| Other assets   | (2,419)                                 | 128              |
| Accounts payable   | (5,194)                                 | 6,117            |
| Accrued and other liabilities  | (359)                                   | 943              |
| Net cash flows provided by discontinued operations                                 | 7,190                                   | 2,557            |
| <b>Net cash provided by operating activities</b>                                   | <b>13,684</b>                           | <b>2,664</b>     |
| Cash flows from investing activities:  |   |                  |
| Proceeds from sale of Consumer Division  | 43,043                                  |                  |
| Acquisition of business  |   | (500)            |
| Purchase of furniture, fixtures and equipment                                      | (4,147)                                 | (938)            |
| Proceeds from sale of furniture, fixtures and equipment                            | 38                                      |                  |
| Net cash flows provided by discontinued operations                                 | 27                                      |                  |
| <b>Net cash provided by (used in) investing activities</b>                         | <b>38,961</b>                           | <b>(1,438)</b>   |
| Cash flows from financing activities:  |   |                  |
| Proceeds from exercise of stock options  | 3,061                                   | 648              |
| Tax benefit of employee stock option exercise                                      | 4,062                                   | 198              |
| <b>Net cash provided by financing activities</b>                                   | <b>7,123</b>                            | <b>846</b>       |
| <b>Net increase in cash</b>  | <b>59,768</b>                           | <b>2,072</b>     |
| Cash and cash equivalents at beginning of period                                   | 40,907                                  | 60,006           |
| <b>Cash and cash equivalents at end of period</b>                                  | <b>\$ 100,675</b>                       | <b>\$ 62,078</b> |
| Supplemental schedule of noncash investing activities:                             |   |                  |
| Receivable from Integrated Circuit Solution Incorporation used to fund acquisition | \$                                      | \$ 1,000         |



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See accompanying notes to unaudited consolidated financial statements.

**Table of Contents****STEC, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited)****Note 1 Basis of Presentation**

The accompanying interim consolidated financial statements of STEC, Inc., a California corporation (the Company), are unaudited and have been prepared in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X. In the opinion of management, all adjustments (consisting only of normal and recurring adjustments) considered necessary for a fair statement of the consolidated financial position of the Company at March 31, 2007, the consolidated results of operations for each of the three months ended March 31, 2007 and 2006, and the consolidated results of cash flows for each of the three months ended March 31, 2007 and 2006 have been included. These interim consolidated financial statements should be read in conjunction with the consolidated financial statements and related notes contained in the most recent Annual Report on Form 10-K filed with the SEC. The December 31, 2006 balances reported herein are derived from the audited consolidated financial statements included in the Annual Report on Form 10-K for the year ended December 31, 2006. The results for the interim periods are not necessarily indicative of results to be expected for the full year.

On February 9, 2007, the Company completed the sale of assets relating to the Consumer Division of the Company (Note 3). The Company has accounted for this transaction as a discontinued operation in accordance with Statement of Financial Accounting Standards (SFAS) No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. Accordingly, the Company's consolidated financial statements have been presented to reflect the Consumer Division as a discontinued operation for all periods presented. Unless noted otherwise, discussions in the notes to consolidated financial statements pertain to continuing operations. As a result of the reclassification of the Consumer Division, which was previously reported as a separate operating segment, the Company now operates as a single reportable segment.

The consolidated financial statements of the Company include the accounts of the Company's subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

**Note 2 Summary of Significant Accounting Policies***Reclassification:*

Certain amounts previously reported have been reclassified to conform with the 2007 presentation.

*Use of Estimates:*

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make certain estimates and assumptions that affect the reported amounts of assets and liabilities (e.g., bad debt reserves and inventory reserves), disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

*Concentrations:*

As shown in the table below, customer concentrations of accounts receivable and revenues of greater than 10% were as follows:

|            | For the Three Months Ended March 31, |          |                     |          |
|------------|--------------------------------------|----------|---------------------|----------|
|            | 2007                                 |          | 2006                |          |
|            | Accounts Receivable                  | Revenues | Accounts Receivable | Revenues |
| Customer A | 48%                                  | 53%      | 45%                 | 36%      |
| Customer B | *                                    | *        | 26%                 | 24%      |

\* Less than 10%

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For each of the three months ended March 31, 2007 and 2006, international sales comprised 21% and 12%, respectively, of the Company's revenues. No single foreign country accounted for more than 10% of revenues during each of the three months ended March 31, 2007 and 2006. Substantially all of the Company's international sales are export sales, which are shipped from the Company's domestic facility to foreign customers.

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### *Revenue Recognition:*

Pursuant to the Securities and Exchange Commission Staff Accounting Bulletin No. 104, Revenue Recognition, the Company recognizes revenue when there is persuasive evidence of an arrangement, delivery has occurred or services have been rendered, the sales price is determinable, and collectibility is reasonably assured. The Company typically recognizes revenue at time of shipment.

In addition, effective January 1, 2007, the Company entered into a value-add revenue agreement with one of its DRAM customers. Under the terms of the agreement, the Company is no longer the primary obligor, and the Company's general inventory risk on DRAM chips used in the manufacture of memory modules for the customer has been eliminated. As a result, the Company records the related revenue on a value-add only basis, passing through the cost of the DRAM chips and charging the customer only for the manufacturing and kitting services provided by the Company. This method of accounting for such value-add revenue is commonly used by competitors doing business in the OEM DRAM module sector. This accounting method conforms to the Emerging Issues Task Force (EITF) Issue No. 99-19, Reporting Revenue as a Principal versus Net as an Agent.

### *Warranties:*

The Company's products are generally sold under various limited warranty arrangements, which range from one year to the product's lifetime. Estimated warranty costs are recorded concurrently with the recognition of revenue. Historically, the costs of repairs or replacement have been immaterial and have approximated management's estimates.

### *Sales and marketing incentives:*

Sales and marketing incentives were offset against revenues or charged to operations in accordance with Emerging Issues Task Force (EITF) Issue No. 01-09, Accounting for Consideration Given by a Vendor to a Customer or a Reseller of the Vendor Products. Sales and marketing incentives, which amounted to \$425,000 and \$298,000 for each of the three months ended March 31, 2007 and 2006, respectively, were offset against revenues.

Consideration generally given by the Company to a customer is presumed to be a reduction of selling price, and therefore, a reduction of revenue. However, if the Company receives an identifiable benefit in return for the consideration given to its customer that is sufficiently separable from the Company's sales to that customer, such that the Company could have paid an independent company to receive that benefit, and the Company can reasonably estimate the fair value of that benefit, then the consideration is characterized as an expense.

### *Shipping and handling costs:*

Shipping and handling costs incurred in a sales transaction to ship products to a customer are included in sales and marketing expenses. Amounts billed to customers for shipping and handling are included in revenues.

### *Income taxes:*

Deferred income taxes are recognized for the tax consequences in future years of differences between the tax bases of assets and liabilities and their financial reporting amounts at each year-end based on enacted tax laws and statutory rates applicable to the periods in which the differences are expected to affect taxable income. Valuation allowances are established, when necessary, to reduce deferred income tax assets to the amount expected to be realized. The provision for income taxes represents the tax payable for the year and the change during the year in deferred income tax assets and liabilities. The difference between the effective tax rate and the U.S. statutory tax rate for each of the three months ended March 31, 2007 and 2006 reflects the benefit of tax exempt interest income, the recognition of federal tax credits related to research and development, increased by the net impact of state taxes and decreased by the state benefit related to research and development credits and enterprise zone hiring credits.

On January 1, 2007, the Company adopted FIN 48 which establishes a single model to address accounting for uncertain tax positions. FIN 48 clarifies the accounting for income taxes by prescribing a minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. FIN 48 also provides guidance on derecognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure and transition. See Note 5 to the unaudited consolidated financial statements.



**Table of Contents***New accounting pronouncements:*

In September 2006, the Financial Accounting Standards Board ( FASB ) issued SFAS No. 157, Fair Value Measurements, which defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles, and expands disclosures about fair value measurements. The Company will adopt the provisions of SFAS No. 157 effective January 1, 2008. The Company does not expect SFAS No. 157 to have a material impact on its results of operations, financial position, or cash flows.

In February 2007, FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities which permits entities to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. SFAS No. 159 will be effective on January 1, 2008. The Company is evaluating the effect the adoption of this standard will have on its consolidated financial position, results of operations and cash flows.

The Company has implemented all new accounting pronouncements that are in effect and that may impact its consolidated financial statements and does not believe that there are any other new accounting pronouncements that have been issued that might have a material impact on its consolidated financial statements.

**Note 3 Discontinued Operations**

On February 9, 2007, the Company entered into an Asset Purchase Agreement ( Purchase Agreement ) with Fabrik, Inc. ( Fabrik ) and Fabrik Acquisition Corp. (together with Fabrik, the Purchasers ) for the sale of assets relating to a portion of the Company's business which was engaged in the designing, final assembling, selling, marketing and distributing consumer-oriented products based on Flash memory, DRAM and external storage technologies known as the Consumer Division of the Company. The consideration paid to the Company pursuant to the Purchase Agreement consisted of cash in the amount of approximately \$43.0 million, which was \$10.0 million above the net working capital of the Consumer Division. The purchase price is subject to a post-closing adjustment for accrued expenses, reserves on inventory, reserves on accounts receivables and overhead capitalization of the Consumer Division. In connection with the consummation of the sale of the assets of the Consumer Division, the Purchasers hired substantially all of the employees of the Consumer Division. The sale of assets included the SimpleTech name and the Company effected a corporate name change on March 7, 2007 from SimpleTech, Inc. to STEC, Inc.

In connection with the sale, the Company entered into an indemnity agreement with Fabrik's lender related to certain consigned inventory aggregating approximately \$8.5 million held by two Consumer Division customers for resale as of February 9, 2007. The indemnity is limited to (i) any losses on the consigned inventory incurred by Fabrik's lender directly related to their inability to have access to the consigned inventory during the 60 day period commencing from February 9, 2007 and (ii) any losses incurred by Fabrik's lender on the consigned inventory related to a claim of superior title to, or interest in, any consigned inventory during the 6 month period from February 9, 2007, as a result of the Company's failure to perfect its security interest in the consigned inventory. Any potential claims are reduced as the customers remit payments to Fabrik on the consigned inventory. As of March 31, 2007, no amounts have been claimed under this indemnity agreement.

The sale of the assets of the Consumer Division meets the criteria defined in SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets as discontinued operations and is presented herein as such. Prior year financial results have been presented to reflect the Consumer Division as discontinued operations.

Operating results of the Consumer Division as discontinued operations for the three months ended March 31, 2007 and 2006 are summarized as follows (in thousands):

|  | <b>For the Three Months Ended March 31,</b> |             |
|--|---|-------------|
|  | <b>2007</b>                                 | <b>2006</b> |
| Net sales                                | \$ 28,693                                   | \$ 25,058   |
| Gain on disposition of Consumer Division | \$ 7,967                                    | \$          |
| Loss from discontinued operations        | (244)                                       | (133)       |
| Income tax benefit (provision)           | (3,066)                                     | 53          |
| Income (loss) on discontinued operations | \$ 4,657                                    | \$ (80)     |

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Assets and liabilities of the discontinued operation included in the consolidated balance sheet as of December 31, 2006 are as follows (in thousands):

|   | <b>December 31, 2006</b> |
|---|--------------------------|
| Accounts receivable                                   | \$ 33,903                |
| Inventory   | 23,977                   |
| <b>Current assets of discontinued operations</b>      | <b>\$ 57,880</b>         |
| Accounts payable                                      | \$ 7,442                 |
| Accrued and other liabilities                         | 4,985                    |
| <b>Current liabilities of discontinued operations</b> | <b>\$ 12,427</b>         |

**Table of Contents****Note 4 Acquisition**

On January 15, 2006, the Company completed the acquisition of the Flash controller group of the logic division of Integrated Circuit Solution Incorporation. This group designs and manufactures Flash memory controller products and is located in Hsin Chu, Taiwan. The Company acquired the Flash controller group for approximately \$1.5 million. This acquisition enables the Company to develop Flash memory controllers that are customized for its products. In addition, it provides the Company with a set of resources to pursue this customization without having to locate, hire, and train a new team of engineers to fulfill this task.

The acquisition was accounted for as a purchase under SFAS No. 141, Business Combinations. The valuation is finalized and the allocation of the excess of the purchase price over the estimated fair value of the net tangible assets acquired is included in goodwill as follows (in thousands):

|   |                 |
|---|-----------------|
| Current assets                                | \$              |
| Fixed assets                                  | 1,050           |
| <b>Fair value of tangible assets acquired</b> | <b>1,050</b>    |
| Goodwill                                      | 450             |
| <b>Consideration</b>                          | <b>\$ 1,500</b> |

**Note 5 Income Taxes**

In July 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109 ( FIN 48 ), which clarifies the accounting for uncertainty in tax positions. This Interpretation requires that the Company recognize in its financial statements the impact of a tax position if that position will more likely than not be sustained on audit, based on the technical merits of the position.

The Company adopted the provisions of FIN 48 on January 1, 2007. As a result of the adoption of FIN 48 and recognition of the cumulative effect of adoption of a new accounting principle, we recorded a \$73,000 increase in the liability for unrecognized income tax benefits, with an offsetting decrease in retained earnings as of January 1, 2007. As of January 1, 2007, the Company had approximately \$1.4 million of total unrecognized tax benefits of this total, \$1.1 million (net of the federal benefit on state issues) represents the amount of unrecognized tax benefits that, if recognized, would favorably affect the effective income tax rate in any future periods. The amount of unrecognized tax benefits did not materially change as of March 31, 2007. The Company does not anticipate that unrecognized tax benefits will significantly increase or decrease within 12 months of the reporting date.

The tax years 2003 to 2006 and 2002 to 2006 remain open to examination by United States and certain state taxing jurisdictions, respectively.

The Company recognizes interest and penalties related to unrecognized tax benefits and penalties in the tax provision. As of January 1, 2007, the Company had recorded a liability of \$73,000 for the payment of interest and penalties. The liability for the payment of interest and penalties did not materially change as of March 31, 2007.

**Note 6 Net Income Per Share**

Basic earnings per share is computed by dividing net income by the weighted average number of shares outstanding. In computing diluted earnings per share, the weighted average number of shares outstanding is adjusted to reflect the potentially dilutive securities. Options to purchase 5,488,764 and 9,996,441 shares of common stock were outstanding at March 31, 2007 and 2006, respectively. In addition, 504,500 restricted stock units payable in shares of common stock were outstanding at March 31, 2007. There were no outstanding restricted stock units at March 31, 2006. For each of the three months ended March 31, 2007 and 2006, potentially dilutive securities consisted solely of options and restricted stock units and resulted in potential common shares of 2,772,880 and 1,058,028, respectively.



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Inventory consists of the following (in thousands):

|                      | <b>March 31, 2007</b> | <b>December 31, 2006</b> |
|----------------------|-----------------------|--------------------------|
| Raw materials        | \$ 37,995             | \$ 41,053                |
| Work-in-progress     | 827                   | 1,302                    |
| Finished goods       | 12,550                | 10,773                   |
|                      | 51,372                | 53,128                   |
| Valuation allowances | (2,314)               | (1,675)                  |
| Inventory, net       | \$ 49,058             | \$ 51,453                |

The Company has had to write down inventory in the past for reasons such as obsolescence, excess quantities and declines in market value below its costs. These inventory write-downs were \$855,000 and \$134,000 in the three months ended March 31, 2007 and 2006, respectively.

Accrued and other liabilities consisted of the following (in thousands):

|               | <b>March 31, 2007</b> | <b>December 31, 2006</b> |
|---------------|-----------------------|--------------------------|
| Payroll costs | \$ 4,995              | \$ 4,710                 |
| Other         | 545                   | 2,401                    |
| Total         | \$ 5,540              | \$ 7,111                 |

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### **Note 8 Commitments and Contingencies**

#### **Lemelson Medical, Education & Research Foundation, LLP Patent Infringement**

The Company received notice on November 26, 2001 that the Lemelson Medical, Education & Research Foundation, LLP ( Lemelson Foundation ) filed a complaint on November 13, 2001 against the Company and other defendants. The complaint was filed in the District Court of Arizona and alleges that the Company s manufacturing processes infringe several patents that the Lemelson Foundation allegedly owns. The complaint also states that these allegedly infringed patents relate to machine vision technology and bar coding technology. On March 7, 2002, the Company was served with the Lemelson Foundation complaint. Thereafter, the case was stayed pending the outcome of related cases against other parties involving the same patents. On September 9, 2005, in one of these related cases, the U.S. Court of Appeals for the Federal Circuit affirmed a decision by the U.S. District Court for the District of Nevada that found several Lemelson Foundation patents to be unenforceable. Because the final outcome of the related cases are expected to affect the Lemelson Foundation s lawsuit against the Company, an estimate of potential damages, if any, would be premature and speculative. The Company believes this lawsuit is without merit and it intends to vigorously defend itself against it. As of March 31, 2007, no amounts have been recorded in the consolidated financial statements for this matter as management believes an unfavorable outcome is not probable.

#### **Hard Drive Class Action Lawsuit**

On October 6, 2006, an individual, Boris Brand, filed a purported nationwide class action lawsuit against the Company in the Superior Court for the State of California, County of Los Angeles, alleging that the Company s description of the capacity of its hard drive products constitutes fraudulent, unfair, deceptive and false advertising under California Business and Professions Code Sections 17200 and 17500 and violates the California Consumers Legal Remedies Act. In particular, the lawsuit alleges that the Company s description of the storage capacity on its hard drives uses a decimal basis for measuring gigabytes which results in a lower storage capacity when the hard drives are incorporated into an operating system that uses a binary gigabyte basis for measurement. Plaintiff seeks restitution, disgorgement, compensatory damages and injunctive relief and attorneys fees. The Company believes this lawsuit is without merit and it intends to vigorously defend itself against it. The Company has submitted the defense of this lawsuit to its insurance carrier. Also, the Company has notified all of the suppliers who have supplied it with the hard drives involved, since the Company believes that those suppliers have a legal duty to indemnify it in the event that the Company has to pay any damages. There can be no assurance, however, that the Company s insurance carrier will ultimately agree to defend this lawsuit on the Company s behalf or that any of the Company s suppliers will indemnify it for any damages resulting from this lawsuit. As of March 31, 2007, no amounts have been recorded in the consolidated financial statements for this matter as management believes it is too early in the proceedings to determine a final outcome.

#### **Napster Lawsuit**

On February 14, 2006, the Company filed a lawsuit against Napster, LLC, a licensor, in the Superior Court for the State of California, County of Los Angeles, alleging breach of contract and fraud and demanding monetary damages. On March 2, 2007, Napster filed a cross-complaint against the Company for breach of contract, fraud, and other claims. The Company plans to pursue its claims and rebuke the counter-claims vigorously, however, it is not possible at this time to estimate the outcome of this matter. As of March 31, 2007, no amounts have been recorded in the consolidated financial statements for this matter as management believes an unfavorable outcome is not probable.

#### **Other Legal Proceedings**

The Company is currently not a party to any other material legal proceedings. However, the Company is involved in other suits and claims in the ordinary course of business, and the Company may from time to time become a party to other legal proceedings arising in the ordinary course of business.

As is common in the industry, the Company currently has in effect a number of agreements in which the Company has agreed to defend, indemnify and hold harmless certain of its suppliers and customers from damages and costs which may arise from the infringement by the Company s products of third-party patents, trademarks or other proprietary rights. The scope of such indemnity varies, but may, in some instances, include indemnification for damages and expenses, including attorneys fees. The Company s insurance does not cover intellectual property infringement. The term of these indemnification agreements is generally perpetual any time after execution of the agreement. The maximum potential amount of future payments the Company could be required to make under these indemnification agreements is unlimited. The Company has never incurred significant costs to defend lawsuits or settle claims related to these indemnification agreements. As a result, the Company believes the estimated fair value of these agreements is minimal. Accordingly, the Company has no liabilities recorded for these agreements as of March 31, 2007.



**Table of Contents****Note 9 Intangible Assets and Goodwill**

The following table presents detail of the Company's intangible assets, related accumulated amortization and goodwill (in thousands):

|                                     | As of March 31, 2007 |                          |                 | As of December 31, 2006 |                          |                 |
|-------------------------------------|----------------------|--------------------------|-----------------|-------------------------|--------------------------|-----------------|
|                                     | Gross                | Accumulated Amortization | Net             | Gross                   | Accumulated Amortization | Net             |
| Developed technology (five years)   | \$ 1,070             | \$ 263                   | \$ 807          | \$ 1,070                | \$ 209                   | \$ 861          |
| Customer relationships (five years) | 900                  | 364                      | 536             | 900                     | 322                      | 578             |
| <b>Total intangible assets</b>      | <b>\$ 1,970</b>      | <b>\$ 627</b>            | <b>\$ 1,343</b> | <b>\$ 1,970</b>         | <b>\$ 531</b>            | <b>\$ 1,439</b> |
| <br>                                |                      |                          |                 |                         |                          |                 |
| Goodwill                            | \$ 1,682             | \$                       | \$ 1,682        | \$ 1,682                | \$                       | \$ 1,682        |

In accordance with SFAS No. 142, Goodwill and Other Intangible Assets, goodwill and other intangible assets with indeterminate lives are not subject to amortization but are tested for impairment annually or whenever events or changes in circumstances indicate that the asset might be impaired. Intangible assets with finite lives continue to be subject to amortization, and any impairment is determined in accordance with SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. The Company recorded amortization expense of \$96,000 and \$62,000 for each of the three months ended March 31, 2007 and 2006, respectively. Estimated intangible asset amortization expense (based on existing intangible assets) for the remainder of the year ending December 31, 2007 and the years ending December 31, 2008, 2009, 2010 and 2011 is \$283,000, \$379,000, \$352,000, \$217,000, and \$112,000, respectively. Amortization will be completed as of the end of 2011.

**Note 10 Shareholders Equity**

On January 1, 2006, the Company adopted SFAS No. 123(R), Share-Based Payment, which requires the measurement of the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award. The Company adopted SFAS No. 123(R) using the modified prospective method. Prior to the adoption of SFAS No. 123(R), the Company accounted for stock-based awards to employees and directors using the intrinsic value method in accordance with Accounting Principles Board (APB) Opinion No. 25 as allowed under SFAS No. 123, Accounting for Stock-Based Compensation.

The following table sets forth the total share-based compensation expense included in income from continuing operations (in thousands):

|                            | For the Three Months Ended |      |
|----------------------------|----------------------------|------|
|                            | March 31, 2007             | 2006 |
| Sales and marketing        | \$ 71                      | \$ 2 |
| General and administrative | 40                         |      |
| Research and development   | 129                        |      |
|                            | \$ 240                     | \$ 2 |

**2000 Stock Incentive Plan**

The 2000 Stock Incentive Plan, as amended and restated (the Plan), was adopted by the Company's board of directors and approved by its shareholders in September 2000. On April 17, 2006, the Plan was amended and restated by the Board and approved by the Company's shareholders on May 25, 2006. The Plan provides for the direct issuance or sale of shares and the grant of options to purchase shares of the Company's common stock to officers and other employees, non-employee board members and consultants. Under the Plan, eligible participants may be granted options to purchase shares of common stock at an exercise price not less than 100% of the fair market value of those shares on the grant date. In addition, the Plan allows for the issuance of restricted stock units to officers and other employees, non-employee board members and consultants. Restricted stock units are share awards that entitle the holder to receive shares of the Company's common stock upon

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vesting. The Company's board of directors, its compensation committee or its equity awards committee determines eligibility and vesting schedules for options and restricted stock units granted under the Plan. Options expire within a period of not more than ten years from the date of grant.

At March 31, 2007, the Plan provided for the issuance of up to 19,173,758 shares of common stock. The number of shares of common stock reserved for issuance under the Plan will automatically increase on the first trading day in January in each calendar year by an amount equal to 4% of the total number of shares of common stock outstanding on the last trading day in December of the prior calendar year, but in no event will exceed 2,500,000 shares.

**Table of Contents****Stock Options**

A summary of the option activity under the Plan is as follows:

|                                | Shares    | Weighted-Avg<br>Option<br>Price | Weighted-Avg<br>Remaining<br>Contractual Term | Aggregate Intrinsic<br>Value |
|--------------------------------|-----------|---------------------------------|---|------------------------------|
| Outstanding, December 31, 2006 | 6,451,032 | \$ 4.48                         |   |                              |
| Granted                        |           |                                 |   |                              |
| Exercised                      | (944,268) | 4.02                            |   |                              |
| Forfeited/Expired              | (18,000)  | 3.40                            |   |                              |
| Outstanding, March 31, 2007    | 5,488,764 | 4.57                            | 6.71  | \$ 14,241,683                |
| Exercisable, March 31, 2007    | 5,460,014 | 4.56                            | 6.70  | 14,182,783                   |

During the three months ended March 31, 2007, the Company received \$3,061,000 in cash proceeds for the exercise of 944,268 options with a \$4,062,000 tax benefit for disqualifying dispositions of incentive stock options. The intrinsic value for options exercised for the three months ended March 31, 2007 was \$3,921,776.

As of March 31, 2007, total unrecognized compensation expense related to unvested share-based compensation arrangements already granted under the Plan was \$91,000, which the Company expects to recognize over a weighted-average period of 3.0 years.

At March 31, 2007, 5,641,134 shares of common stock were available for grant under the Plan.

**Restricted Stock Units**

During the three months ended March 31, 2007, the Company issued 130,000 restricted stock units with a grant fair value per share determined by the closing price of the common stock on the issuance date. Each unit represents the right to receive one share of the Company's common stock as each restricted stock unit vests. The Company records compensation expense for the amount of the grant date fair value over the period which the restrictions lapse. There were no outstanding restricted stock units as of March 31, 2006.

The following table presents a summary of the status of the Company's restricted stock units as of December 31, 2006, and changes during the three months ended March 31, 2007:

|  | Restricted Units | Weighted<br>Average<br>Grant Fair<br>Value |
|--|------------------|--|
| Non-vested restricted units at December 31, 2006 | 387,000          | \$ 6.37                                    |
| Granted  | 130,000          | 12.17                                      |
| Vested   | (12,500)         | 3.89                                       |
| Forfeited  |                  |  |
| Non-vested restricted units at March 31, 2007    | 504,500          | \$ 7.93                                    |

As of March 31, 2007, there was approximately \$3,657,000 of total unrecognized compensation expense related to non-vested restricted stock units granted under the Plan.

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**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

**Cautionary Statement**

Certain statements in this report, including statements regarding our strategy, financial performance and revenue sources, are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, Section 21E of the Securities Exchange Act of 1934, as amended, and Section 27A of the Securities Act of 1933, as amended, and are subject to the safe harbors created by those sections. These forward-looking statements are based on our current expectations, estimates and projections about our industry, management's beliefs, and certain assumptions made by us. Such statements are not guarantees of future performance and are subject to certain risks, uncertainties and assumptions that are difficult to predict. Therefore, our actual results could differ materially and adversely from those expressed in any forward-looking statements as a result of various factors. The section entitled "Risk Factors" set forth in this Form 10-Q and similar discussions in filings with the Securities and Exchange Commission made from time to time, including other quarterly reports on Form 10-Q, our Annual Reports on Form 10-K, and in our other SEC filings, discuss some of the important risk factors that may affect our business, results of operations and financial condition.

The following discussion should be read in conjunction with our consolidated financial statements and notes thereto.

**Discontinued Operations Sale of Consumer Division**

On February 9, 2007, we sold to Fabrik, Inc. and Fabrik Acquisition Corp. a portion of our business which was engaged in designing, final assembling, selling, marketing and distributing consumer-oriented products based on Flash memory, DRAM and external storage technologies known as the Consumer Division. The consideration paid to us consisted of cash in the amount of approximately \$43.0 million, which was \$10.0 million above the net working capital of the Consumer Division. The purchase price is subject to a post-closing adjustment for accrued expenses, reserves on inventory, reserves on accounts receivables and overhead capitalization of the Consumer Division. The sale of assets included the SimpleTech name and we effected a corporate name change on March 7, 2007 from SimpleTech, Inc. to STEC, Inc. The sale of the assets of the Consumer Division meets the criteria defined in Statement of Financial Accounting Standards No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" as a discontinued operation and is presented herein as such. The results of operations and gain on the sale of the assets of the Consumer Division are reported in income from discontinued operations in the Consolidated Financial Statements for all periods presented. Assets and liabilities sold are classified as assets and liabilities of discontinued operations in the Consolidated Balance Sheet as of December 31, 2006. As a result of the sale of the assets of the Consumer Division, which was previously reported as a separate operating segment, we now operate as a single reportable segment.

**Overview**

STEC, Inc. designs, develops, manufactures and markets custom memory solutions based on Flash memory and Dynamic Random Access Memory ( DRAM ) technologies. Prior to the sale of the assets of our Consumer Division in February 2007, we also designed, developed, manufactured and marketed open-standard memory solutions based on Flash memory and DRAM technologies and external storage solutions. Headquartered in Santa Ana, California, we specialize in developing high-density DRAM memory modules and high-speed, high-capacity solid-state Flash drives and memory cards used in sensitive and highly-volatile environments. We offer a comprehensive product line used by original equipment manufacturers, or OEMs.

We sell primarily customized memory solutions for newly-manufactured systems, with most sales based on a cooperative design effort between our design engineers and our OEM customers. We believe the ability of these equipment manufacturers to shorten product development cycles and accelerate time-to-market is critical to their success. In response to this trend, we believe equipment manufacturers are increasingly outsourcing the design, development and manufacturing of memory products to third-party memory providers, such as STEC. We believe our design, manufacturing, testing and logistics expertise, along with our proprietary technologies, enable us to respond quickly to our customers rapidly changing product and service requirements as well as meet their time-to-market schedules.

We are focusing on several revenue growth initiatives, including:

Developing and qualifying customized OEM Flash-based products, including our Zeus and Zeus<sup>IOPS</sup> Solid State Drive product lines, for industrial applications;

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Targeting new customers for our value-add OEM DRAM memory solutions; and

Expanding our international OEM business in Asia and Europe.

Over the past several years, we have expanded our custom design capabilities of Flash products for OEM applications. We have invested significantly in the design and development of customized OEM Flash controllers, firmware and hardware



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form factors. We expanded our OEM Flash design capabilities and sales and marketing infrastructure through our acquisition in July 2005 of Memtech SSD, Corporation, a provider of ultra-rugged and reliable solid state Flash drives. The acquisition highlighted our continuing commitment to the OEM Flash market and enabled us to create one of the most comprehensive offerings of solid state drives and other Flash-based solutions for industrial and military applications. In January 2006, we acquired substantially all of the assets of the Flash controller group of the logic division of Integrated Circuit Solution Incorporation, a Taiwanese company, adding a team of engineers specializing in Flash controller design. In October 2006, we acquired substantially all of the assets of Gnutek Ltd., a privately-held company based in the United Kingdom that designs and develops high-performance NAND Flash-based solid state drives. This acquisition enables us to offer products that address the enterprise server and storage market's rapidly increasing need for Flash-based drive solutions. We believe that our continued investment in our OEM Flash capabilities will positively impact the future growth of our OEM Flash revenues.

As noted above, a major area of our OEM Flash-based product investment has been focused on solid state drive (SSD) technology. We believe the advantages of SSD technology are currently being defined in at least three distinct market segments. First, where ultra-high throughput solutions are sought, SSDs provide enormous and measurable performance advantages and cost savings over alternative hard drive products, such as enterprise server and storage applications. Second, where ruggedized drive solutions are critical for data retention, SSDs provide unparalleled durability in military and industrial applications. And finally in the early adoption PC, mobile computing and consumer-related markets that require low-costs and small form factors, the cost-benefit comparison to traditional HDD solutions is becoming increasingly compelling. In the emerging SSD markets for PC- and mobile- computing and consumer-related markets, we hope to establish possible partnership opportunities with Flash semiconductor manufacturers who could potentially leverage our IP in hardware, firmware, manufacturing and testing while utilizing their low cost Flash components and customer relationships to bring to market the best technology at the most competitive price. We see opportunities to leverage our SSD expertise across each of these three markets where we believe our technology can outperform existing solutions. In addition, we believe the SSD market will continue to develop over the next few years, aided by the continuation of the decline in Flash component pricing, with the overall unit volumes continuing to grow over the next several years.

OEM Flash product revenue increased 42.9% from \$16.8 million in the first quarter of 2006 to \$24.0 million in the first quarter of 2007. We expect our continued investments in OEM Flash custom design capabilities and controller development to result in sustained revenue growth from our OEM Flash product line in 2007. OEM Flash product gross margins were our highest gross margin product line in 2006.

We offer both monolithic DRAM memory modules as well as DRAM memory modules based on our stacking technology. Prior to 2005, a substantial portion of our OEM DRAM business had been comprised of stacked DRAM memory modules. As a result of the introduction of new DRAM technologies, we expect that a higher percentage of our OEM DRAM business will be derived from monolithic DRAM memory modules. In recent quarters, our OEM DRAM memory module revenues have been volatile and difficult to project, and we expect this product line to remain difficult to project for the next several quarters as our customers continue to qualify the latest generation modules.

We continue to make progress toward one of our long-term revenue growth initiatives to expand our international business in Asia and Europe. Since the beginning of 2004, we have opened sales, marketing, procurement and engineering offices in Austria, France, Hong Kong, Japan, the Netherlands, Taiwan and the United Kingdom in order to build the necessary infrastructure to support revenue growth in those geographic regions. We are also building a manufacturing facility in Malaysia, which we expect to help us reduce average production and engineering labor costs, have better access to growing markets in Asia, improve supply chain efficiency, reduce lead times, increase manufacturing efficiency through investments in new state-of-the-art equipment and lower our overall long-term effective tax rate. However, we anticipate pre-opening costs related to the start-up of the Malaysia manufacturing facility to negatively impact our earnings in the short-term. For the first quarter of 2007, we incurred approximately \$0.5 million of pre-opening expenses related to the establishment of this facility. The 200,000 square foot manufacturing facility in Malaysia is expected to be operational in the first quarter of 2008.

Historically, a limited number of customers have accounted for a significant percentage of our revenue. Our ten largest customers accounted for an aggregate of 73.5% of our revenues in the first three months of 2007, compared to 78.8% of our total revenues in the first three months of 2006. The following table identifies each of our customers that accounted for more than 10.0% of our revenues in any of the three months ended March 31, 2007 and 2006.

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|                      | Percentage of Revenues<br>for the Three Months Ended<br>March 31, |      |
|----------------------|---|------|
|                      | 2007  | 2006 |
| Smart Modular        | 53%   | 36%  |
| Micron Semiconductor | *   | 24%  |

\* Less than 10%

The composition of our major customer base changes from quarter to quarter as the market demand for our products changes, and we expect this variability will continue in the future. We expect that sales of our products to a limited number of customers will continue to account for a majority of our revenues in the foreseeable future. The loss of, or a significant reduction in purchases by any of our major customers, would harm our business, financial condition and results of operations. See **Risk Factors** Sales to a limited number of customers represent a significant portion of our revenues and the loss of any key customer would materially reduce our revenues.

International sales of our products accounted for 20.8% of our revenues in the first three months of 2007, compared to 11.7% of our revenues in the first three months of 2006. No single foreign country accounted for more than 10% of revenues during each of the three months ended March 31, 2007 and 2006. For each of the three months ended March 31, 2007 and 2006, more than 95.0% of our international sales were denominated in U.S. dollars. In addition, our purchases of DRAM and Flash components are currently denominated in U.S. dollars. However, we do face risks associated with doing business in foreign countries. See **Risk Factors** We face risks associated with doing business in foreign countries, including foreign currency fluctuations and trade barriers, that could lead to a decrease in demand for our products or an increase in the cost of the components used in our products.

In the past, we have been, and expect to continue to experience some seasonality in our OEM business resulting in higher sales generally in the fourth quarter of each year due to corporate customers spending to their full capital budgets before the end of each year.

**Results of Operations**

The following table sets forth, for the periods indicated, certain consolidated statement of operations data reflected as a percentage of revenues. In February 2007, we discontinued the operation of our Consumer Division. The table below does not include the revenues and operating expenses of our Consumer Division, which is presented as a discontinued operation in accordance with SFAS No. 144, **Accounting for the Impairment or Disposal of Long-Lived Assets**.

|  | Three Months Ended<br>March 31, |        |
|--|---------------------------------|--------|
|  | 2007                            | 2006   |
| Net revenues                             | 100.0%                          | 100.0% |
| Cost of revenues                         | 69.4                            | 77.3   |
| Gross profit                             | 30.6                            | 22.7   |
| Operating expenses:                      |                                 |        |
| Sales and marketing                      | 9.4                             | 7.4    |
| General and administrative               | 8.1                             | 7.2    |
| Research and development                 | 7.8                             | 5.0    |
| Total operating expenses                 | 25.3                            | 19.6   |
| Operating income                         | 5.3                             | 3.1    |
| Interest income                          | 1.6                             | 1.2    |
| Income before provision for income taxes | 6.9                             | 4.3    |

**Comparison of Three Months Ended March 31, 2007 to Three Months Ended March 31, 2006**

**Net Revenues.** Our revenues were \$47.2 million in the first quarter of 2007, compared to \$40.4 million in the same period in 2006. Revenues increased 16.7% in the first quarter of 2007 due primarily to an 80.6% increase in unit shipments, partially offset by a 35.0% decrease in average sales price, or ASP, from \$60 in the first quarter of 2006 to \$39 in the first quarter of



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2007. The decrease in our ASP resulted primarily from a significant shift in product mix toward lower-ASP, lower-capacity (but higher gross margin), Flash memory products. The increase in unit shipments resulted primarily from a 68.6% increase in Flash memory units shipped. Flash product shipments increased due to an increase in orders from new and existing customers in the first quarter of 2007.

Sales of our products are made under short-term cancelable purchase orders. We include in our backlog only those customer orders for which we have accepted purchase orders and to which we have assigned shipment dates within the upcoming six months. Since orders constituting our backlog are subject to change due to, among other things, customer cancellations and reschedulings, and our ability to procure necessary components, backlog is not necessarily an indication of future revenues. In addition, there can be no assurance that current backlog will necessarily lead to revenues in any future period. Our backlog was \$19.8 million as of March 31, 2007, compared to \$14.3 million as of March 31, 2006. The increase in backlog at March 31, 2007 compared to March 31, 2006 was primarily due to increased orders primarily for our Flash product lines in the first quarter of 2007. Our ability to predict future sales is limited because a majority of our quarterly product revenues come from orders that are received and fulfilled in the same quarter.

*Gross Profit.* Our gross profit was \$14.4 million in the first quarter of 2007, compared to \$9.2 million in the same period in 2006. Gross profit as a percentage of revenues was 30.6% in the first quarter of 2007, compared to 22.7% in the first quarter of 2006. Gross profit as a percentage of revenue in the first quarter of 2007 increased due primarily to a shift in product mix toward higher gross profit margin Flash products.

*Sales and Marketing.* Sales and marketing expenses are primarily comprised of personnel costs and travel expenses for our domestic and international sales and marketing employees, commissions paid to internal salespersons and independent manufacturers' representatives, shipping costs and marketing programs. Sales and marketing expenses were \$4.4 million in the first quarter of 2007, compared to \$3.0 million in the first quarter of 2006. Sales and marketing expenses as a percentage of revenue were 9.4% in the first quarter of 2007, compared to 7.4% in the first quarter of 2006. The increase in sales and marketing expenses in absolute dollars and as a percentage of revenues was due primarily to an increase in commissions paid and shipping expenses as a result of a higher revenue level, an increase in units shipped, the addition of sales and marketing personnel hired to execute on our revenue growth initiatives, such as expansion in Asia, and to support the continued revenue expansion of our Flash products. We expect our sales and marketing expenses to increase in absolute dollars as our revenues grow.

*General and Administrative.* General and administrative expenses are primarily comprised of personnel costs for our executive and administrative employees, professional fees and facilities overhead. General and administrative expenses were \$3.8 million in the first quarter of 2007, compared to \$2.9 million in the first quarter of 2006. General and administrative expenses as a percentage of revenues were 8.1% in the first quarter of 2007, compared to 7.2% in the first quarter of 2006. The increase in general and administrative expenses in absolute dollars and as a percentage of revenues was due primarily to increases in payroll costs, accounting and audit costs, including Sarbanes-Oxley implementation costs, and legal fees. We expect our general and administrative expenses to increase in absolute dollars as our sale unit volumes and revenues grow.

*Research and Development.* Research and development expenses are comprised primarily of personnel costs for our engineering and design staff and the cost of prototype supplies. Research and development expenses were \$3.7 million in the first quarter of 2007, compared to \$2.0 million in the first quarter of 2006. Research and development expenses as a percentage of revenues were 7.8% in the first quarter of 2007 compared to 5.0% in first quarter of 2006. Research and development expenses increased due primarily to an increase in payroll costs from our expanding global research and development efforts predominantly related to our Flash product line.

*Interest Income.* Interest income was \$761,000 in the first quarter of 2007 and \$475,000 in the first quarter of 2006. Interest income is comprised of interest earned on our cash, cash equivalents and marketable securities. This increase in interest income resulted primarily from higher interest rates and higher average cash balance in the first quarter of 2007 compared to the first quarter of 2006.

*Income from Continuing Operations Before Income Taxes.* Income from continuing operations before income taxes increased from \$1.7 million in the first quarter of 2006 to \$3.2 million in the first quarter of 2007.

*Provision for Income Taxes.* The provision for income taxes increased from \$582,000 in the first quarter of 2006 to \$1.2 million in the first quarter of 2007 due primarily to the increase in income from continuing operations before income taxes from \$1.7 million in the first quarter of 2006 to \$3.2 million in the first quarter of 2007. As a percentage of income before provision for income taxes, provision for income taxes increased from 34.2% in the first quarter of 2006 to 36.3% in the first quarter of 2007 due primarily to higher stock compensation expense in 2007, which partially offset the benefit from the tax interest income in 2007.

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*Income (Loss) from Discontinued Operation, Net of Taxes.* As previously mentioned above, we sold the assets of our Consumer Division on February 9, 2007. As a result of the sale, the Consumer Division is now reflected as discontinued operations in accordance with SFAS No. 144,

Accounting for the Impairment or Disposal of Long-Lived Assets. Income (loss) from discontinued operations, net of taxes increased from a net loss of \$80,000 in the first quarter of 2006 to net income of \$4.7 million in the first quarter of 2007 primarily due to the gain of sale, net of taxes, of \$4.9 million in 2007.

**Liquidity and Capital Resources**
***Working Capital, Cash and Marketable Securities***

As of March 31, 2007, we had working capital of \$158.9 million, including \$100.7 million of cash and cash equivalents, compared to working capital of \$147.6 million, including \$40.9 million of cash and cash equivalents as of December 31, 2006 and working capital of \$112.8 million, including \$62.1 million of cash and cash equivalents as of March 31, 2006. Current assets were 8.4 times current liabilities at March 31, 2007, compared to 4.6 times current liabilities at December 31, 2006, and 4.8 times current liabilities at March 31, 2006.

***Cash Provided by Operating Activities in the Three Months Ended March 31, 2007 and 2006***

Net cash provided by operating activities was \$13.7 million for the three months ended March 31, 2007 and resulted primarily from an \$8.6 million decrease in accounts receivable, net of allowances, a \$2.4 million decrease in inventory, net of reserves, income from continuing operations of \$2.1 million, and cash flows provided by discontinued operations of \$7.2 million, partially offset by a \$5.2 million decrease in accounts payable, and \$2.4 million increase in other assets. Accounts receivable, net of allowances, decreased primarily due to lower sales in the first quarter of 2007 compared to the fourth quarter of 2006. Inventory, net of reserves, decreased due to an increase in inventory reserves in the first quarter of 2007 and less purchases of inventory in the first quarter of 2007 as the result of vendor required last time buys on certain inventory items in late 2006 which supported customer demand through the first quarter of 2007. Inventory write-downs increased from \$134,000 for three months ended March 31, 2006 to \$855,000 for the three months ended March 31, 2007 primarily due to a decline in market prices for certain inventory parts. The cash provided by discontinued operations of the Consumer Division for the three months ended March 31, 2007 was primarily due to working capital changes and \$4.7 million of income from discontinued operations. Accounts payable decreased as a result of lower inventory purchases for the three months ended March 31, 2007 compared to the three months ended December 31, 2006. Other assets increased by \$2.4 million primarily due to increase in prepayments for inventory purchases.

Net cash provided by operating activities was \$2.7 million for the three months ended March 31, 2006 and resulted primarily from a \$6.1 million increase in accounts payable, \$2.6 million cash provided by discontinued operation, net income of \$1.0 million, \$1.4 million decrease in inventory, net of reserves, non-cash depreciation and amortization of \$961,000 and an increase in accrued and other liabilities of \$943,000, partially offset by a \$10.3 million increase in accounts receivable, net of allowances. Accounts payable increased as a result of an increase in inventory purchases for the three months ended March 31, 2006 compared to the three months ended December 31, 2005. The cash provided by discontinued operation of the Consumer Division for the three months ended March 31, 2006 was primarily due to working capital changes. Accounts receivable, net of allowances, increased primarily due to an increase in sales for the Flash product line orders.

***Cash Provided by (Used in) Investing Activities for the Three Months Ended March 31, 2007 and 2006***

Net cash provided by investing activities was \$39.0 million for the three months ended March 31, 2007 resulting primarily from \$43.0 million cash received in connection with the sale of the assets of our Consumer Division in February 2007, partially offset by \$4.1 million in purchases of furniture, fixtures and equipment. The purchases of furniture, fixtures and equipment were related to production equipment for the United States and Malaysia locations. Net cash used in investing activities for the three months ended March 31, 2006 was \$1.4 million, attributable to cash consideration of \$500,000 paid for the acquisition of a division of Integrated Circuit Solution Incorporation in January 2006 and \$938,000 in purchases of furniture, fixtures and equipment.

As of March 31, 2007, we have made capital expenditures of approximately \$1.4 million for our Malaysia facility primarily related to building construction costs, acquisition of land and purchases of production equipment. We are estimating an investment in land, facilities and capital equipment for our Malaysia facility to total approximately \$28 million over the next 5 years.

***Cash Provided by Financing Activities for the Three Months Ended March 31, 2007 and 2006***

Net cash provided by financing activities was \$7.1 million for the three months ended March 31, 2007 and resulted from \$3.1 million in proceeds realized from the exercise of stock options and \$4.1 million tax benefit from employee stock option exercises. Net cash provided by financing activities was \$846,000 for the three months ended March 31, 2006 and resulted from \$648,000 of proceeds realized from the exercise

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of stock options and a \$198,000 tax benefit from employee stock option exercises.

We believe that our existing assets, cash, cash equivalents and investments on hand, together with cash that we expect to generate from our operations, will be sufficient to meet our capital needs for at least the next twelve months. However, it is possible that we may need or elect to raise additional funds to fund our activities beyond the next year, to expand our

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international operations or to consummate acquisitions of other businesses, products or technologies. We could raise such funds by selling more stock to the public or to selected investors, or by borrowing money. In addition, even though we may not need additional funds, we may still elect to sell additional equity securities or obtain credit facilities for other reasons. We cannot assure you that we will be able to obtain additional funds on commercially favorable terms, or at all. If we raise additional funds by issuing additional equity or convertible debt securities, the ownership percentages of existing shareholders would be reduced. In addition, the equity or debt securities that we issue may have rights, preferences or privileges senior to those of the holders of our common stock.

Although we believe we have sufficient capital to fund our activities for at least the next twelve months, our future capital requirements may vary materially from those now planned. The amount of capital that we will need in the future will depend on many factors, including:

our relationships with suppliers and customers;

the market acceptance of our products;

expansion of our international business, including the opening of offices and facilities in foreign countries;

price discounts on our products to our customers;

our pursuit of strategic transactions, including acquisitions, joint ventures and capital investments;

our business, product, capital expenditure and research and development plans and product and technology roadmaps;

the levels of inventory and accounts receivable that we maintain;

our entrance into new markets;

capital improvements to new and existing facilities;

technological advances; and

competitors responses to our products.

**Contractual Obligations and Off Balance Sheet Arrangements**

Set forth in the table below is our estimate of our significant contractual obligations at March 31, 2007. We do not have off-balance sheet financing arrangements as of March 31, 2007.

| Contractual Obligation | Total | Payment due by period |           |
|------------------------|-------|-----------------------|-----------|
|                        |       | 1-3 years             | 3-5 years |

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|   |                  | Less than<br>1 year |                 |                 | More than<br>5 years |
|---|------------------|---------------------|-----------------|-----------------|----------------------|
| Operating Lease Obligations                           | \$ 6,626         | \$ 849              | \$ 1,362        | \$ 1,216        | \$ 3,199             |
| Non-cancelable capital equipment purchase commitments | 1,276            | 1,276               |                 |                 |                      |
| Non-cancelable inventory purchase commitments         | 7,316            | 7,316               |                 |                 |                      |
| Other non-cancelable purchase commitments             | 280              | 280                 |                 |                 |                      |
| <b>Total</b>  | <b>\$ 15,498</b> | <b>\$ 9,721</b>     | <b>\$ 1,362</b> | <b>\$ 1,216</b> | <b>\$ 3,199</b>      |

### **Inflation**

Inflation was not a material factor in either revenue or operating expenses during each of the first three months ended March 31, 2007 and 2006.

### **Critical Accounting Policies and Estimates**

Our discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amount of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amount of revenues and expenses for each period. The following represents a summary of our critical accounting policies, defined as those policies that we believe are: (a) the most important to the portrayal of our financial condition and results of operations, and (b) that require management's most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effects of matters that are inherently uncertain.



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*Revenue Recognition.* Pursuant to the Securities and Exchange Commission Staff Accounting Bulletin No. 104, Revenue Recognition, we recognize revenue when there is persuasive evidence of an arrangement, delivery has occurred or services have been rendered, the sales price is determinable, and collectibility is reasonably assured. We typically recognize revenue at time of shipment.

In addition, effective January 1, 2007, we entered into a value-add revenue agreement with one of our DRAM customers. Under the terms of the agreement, we are no longer the primary obligor, and our general inventory risk on DRAM chips used in the manufacture of memory modules for the customer has been eliminated. As a result, we record the related revenue on a value-add only basis, passing through the cost of the DRAM chips and charging the customer only for the manufacturing and kitting services provided by us. This method of accounting for such value-add revenue is commonly used by competitors doing business in the OEM DRAM module sector. This accounting method conforms to the Emerging Issues Task Force (EITF) Issue No. 99-19, Reporting Revenue as a Principal versus Net as an Agent.

*Reserves for inventory excess, obsolescence and lower of market values over costs.* We purchase raw materials in quantities that we anticipate will be fully used in the near term. Changes in operating strategy, customer demand and unpredictable fluctuations in market values of raw materials can limit our ability to effectively utilize all of the raw materials purchased and result in finished goods with above market carrying costs which may cause losses on sales to customers. We regularly monitor potential excess, or obsolete, inventory by analyzing the length of time in stock and compare market values to cost. When necessary, we reduce the carrying amount of our inventory to its market value.

*Allowances for doubtful accounts and price protection.* We maintain allowances for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. We review our allowance for doubtful accounts quarterly and all past due balances over 90 days are reviewed for collectibility. Additionally, we maintain allowances for limited price protection rights for inventories of our products held by our customers as a result of recent sales transactions to them. If we reduce the list price of our products, these customers may receive a credit from us. By monitoring our inventory levels with our customers, we estimate the impact of such pricing changes on a regular basis and adjust our allowances accordingly.

*Product returns.* While we may not be contractually obligated to accept returned products, we may determine that it is in our best interest to accept returns in order to maintain good relationships with our customers. We provide for estimated future returns of inventory at the time of sale based on historical experience, and actual results have been within our expectations.

*Sales and marketing incentives.* Sales and marketing incentives are offset against revenues or charged to operations in accordance with Emerging Issues Task Force Issue No. 01-09 (EITF 01-09), *Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor's Products)*. Sales and marketing incentives, which amounted to \$425,000 and \$298,000 for each of the three months ended March 31, 2007 and 2006, respectively, were offset against revenues.

Consideration generally given by us to a customer is presumed to be a reduction of selling price, and therefore, a reduction of revenue. However, if we receive an identifiable benefit in return for the consideration given to our customer that is sufficiently separable from our sales to that customer, such that we could have paid an independent company to receive that benefit; and we can reasonably estimate the fair value of that benefit, then the consideration is characterized as an expense.

*Income taxes.* As part of the process of preparing our consolidated financial statements, we are required to estimate our income taxes in each of the jurisdictions in which we operate. The process incorporates an assessment of the current tax exposure together with temporary differences resulting from different treatment of transactions for tax and financial statement purposes. Such differences result in deferred tax assets and liabilities, which are included within the consolidated balance sheet. The recovery of deferred tax assets from future taxable income must be assessed and, to the extent that recovery is not likely, we establish a valuation allowance. Increases in valuation allowances result in the recording of additional tax expense. Further, if our ultimate tax liability differs from the periodic tax provision reflected in the consolidated statements of operations, additional tax expense may be recorded.

On January 1, 2007, the Company adopted FIN 48 which establishes a single model to address accounting for uncertain tax positions. FIN 48 clarifies the accounting for income taxes by prescribing a minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. FIN 48 also provides guidance on derecognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure and transition. See Note 5 to the unaudited consolidated financial statements.

*Litigation and other contingencies.* Management regularly evaluates our exposure to threatened or pending litigation and other business contingencies. Because of the uncertainties related to the amount of loss from litigation and other business contingencies, the recording of losses relating to such exposures requires significant judgment about the potential range of outcomes. As additional information about current or future litigation or other contingencies becomes available, our management will assess whether such information warrants the recording of additional expense relating to our contingencies. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable. The results of these estimates form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

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*Valuation of long-lived assets.* We assess the potential impairment of long-lived tangible and intangible assets whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Changes in our operating strategy can significantly reduce the estimated useful life of such assets.

*Goodwill and intangible assets.* Goodwill and other intangible assets with indeterminate lives are not subject to amortization but are tested for impairment annually or whenever events or changes in circumstances indicate that the asset might be impaired.

**New Accounting Pronouncements**

In September 2006, the Financial Accounting Standards Board ( FASB ) issued Statement of Financial Accounting Standards ( SFAS ) No. 157, Fair Value Measurements, which defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles, and expands disclosures about fair value measurements. We intend to adopt the provisions of SFAS No. 157 effective January 1, 2008. We do not expect SFAS No. 157 to have a material impact on our results of operations, financial position, or cash flows.

In February 2007, FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities which permits entities to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. SFAS No. 159 will be effective on January 1, 2008. We are evaluating the effect the adoption of this standard will have on our consolidated financial position, results of operations and cash flows.

We have implemented all new accounting pronouncements that are in effect and that may impact our consolidated financial statements and do not believe that there are any other new accounting pronouncements that have been issued that might have a material impact on our consolidated financial statements.

**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK****Interest Rate Risk**

At any time, fluctuations in interest rates could affect interest earnings on our cash and cash equivalents. We believe that the effect, if any, of reasonably possible near term changes in interest rates on our financial position, results of operations, and cash flows would not be material. Currently, we do not hedge these interest rate exposures. The primary objective of our investment activities is to preserve capital. We have not used derivative financial instruments in our investment portfolio.

At March 31, 2007, our cash and cash equivalents were \$100.7 million invested in money market and other interest bearing accounts.

From time to time, we invest in marketable securities, however, at March 31, 2007, our investment in marketable securities was \$0.

If interest rates were to decrease 1%, the result would be an annual decrease in our interest income related to our cash and cash equivalents of approximately \$1.0 million. However, due to the uncertainty of the actions that would be taken and their possible effects, this analysis assumes no such action. Further, this analysis does not consider the effect of the change in the level of overall economic activity that could exist in such an environment.

The carrying amount, principal maturity and estimated fair value of our cash and cash equivalents as of March 31, 2007 were as follows:

|                                 | Expected Maturity Date  |            |                | Fair Value     |
|---------------------------------|-------------------------|------------|----------------|----------------|
|                                 | Before April 1,<br>2008 | Thereafter | Total          | 3/30/07        |
| <b>Investments</b>              |                         |            |                |                |
| Cash and cash equivalents:      |                         |            |                |                |
| Money Market Funds              | \$ 100,675,000          | \$ 0       | \$ 100,675,000 | \$ 100,675,000 |
| Weighted average interest rate  | 4.22%                   |            | 4.22%          | 4.22%          |
| Total cash and cash equivalents | \$ 100,675,000          | \$ 0       | \$ 100,675,000 | \$ 100,675,000 |

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Weighted average interest rate

4.22%

4.22%

4.22%

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More than 95.0% of our international sales are denominated in U.S. dollars. Consequently, if the value of the U.S. dollar increases relative to a particular foreign currency, our products could become relatively more expensive. In addition, we purchase substantially all of our IC components from local distributors of Japanese, Korean and Taiwanese suppliers. Fluctuations in the currencies of Japan, Korea or Taiwan could have an adverse impact on the cost of our raw materials. To date, we have not entered any derivative instruments to manage risks related to interest rate or foreign currency exchange rates.

**ITEM 4. CONTROLS AND PROCEDURES**

(a) *Evaluation of Disclosure Controls and Procedures.* An evaluation as of the end of the period covered by this report was carried out under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, of the effectiveness of our disclosure controls and procedures, as such term is defined under Rule 13a-15(e) and Rule 15d-15 promulgated under the Securities Exchange Act of 1934, as amended (the Exchange Act). Based on their evaluation, our principal executive officer and principal financial officer concluded that our disclosure controls and procedures are effective to ensure that we record, process, summarize, and report information required to be disclosed by us in our quarterly reports filed under the Securities Exchange Act within the time periods specified by the Securities and Exchange Commission's rules and forms.

(b) *Changes in Internal Controls.* During the quarterly period covered by this report, there have not been any changes in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) that have materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

**PART II OTHER INFORMATION****ITEM 1. LEGAL PROCEEDINGS****Lemelson Medical, Education & Research Foundation, LLP Patent Infringement**

We received notice on November 26, 2001, that the Lemelson Medical, Education & Research Foundation, LLP filed a complaint on November 13, 2001, against us and other defendants. The complaint was filed in the District Court of Arizona and alleges that our manufacturing processes infringe several patents that the Lemelson Foundation allegedly owns. The complaint also states that these allegedly infringed patents relate to machine vision technology and bar coding technology. On March 7, 2002, we were served with the Lemelson Foundation complaint. Thereafter, the case was stayed pending the outcome of related cases against parties involving the same patents. On September 9, 2005, in one of these related cases, the U.S. Court of Appeals for the Federal Circuit affirmed a decision by the U.S. District Court for the District of Nevada that found several Lemelson Foundation patents to be unenforceable. Because the final outcome of the related cases are expected to affect the Lemelson Foundation's lawsuit against us, an estimate of potential damages, if any, would be premature and speculative. We believe this lawsuit is without merit and we intend to vigorously defend ourselves against it. As of March 31, 2007, no amounts have been recorded in the consolidated financial statements for this matter as management believes an unfavorable outcome is not probable.

**Hard Drive Class Action Lawsuit**

On October 6, 2006, an individual, Boris Brand, filed a purported nationwide class action lawsuit against us in the Superior Court for the State of California, County of Los Angeles, alleging that our description of the capacity of our hard drive products constitutes fraudulent, unfair, deceptive and false advertising under California Business and Professions Code Sections 17200 and 17500 and violates the California Consumers Legal Remedies Act. In particular, the lawsuit alleges that our description of the storage capacity on our hard drives uses a decimal basis for measuring gigabytes which results in a lower storage capacity when the hard drives are incorporated into an operating system that uses a binary gigabyte basis for measurement. Plaintiff seeks restitution, disgorgement, compensatory damages and injunctive relief and attorneys fees. We believe this lawsuit is without merit and we intend to vigorously defend ourselves against it. We have submitted the defense of this lawsuit to our insurance carrier. Also, we have notified all of the suppliers who have supplied us with the hard drives involved, since we believe that those suppliers have a legal duty to indemnify us in the event we are required to pay any damages. There can be no assurance, however, that our insurance carrier will ultimately agree to defend this lawsuit on our behalf or that any of our suppliers will indemnify us for any damages resulting from this lawsuit. As of March 31, 2007, no amounts have been recorded in the consolidated financial statements for this matter as management believes it is too early in the proceedings to determine a final outcome.

**Napster Lawsuit**

On February 14, 2006, we filed a lawsuit against Napster, LLC, a licensor, in the Superior Court for the State of California, County of Los Angeles, alleging breach of contract and fraud and demanding monetary damages. On March 2, 2007, Napster

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filed a cross-complaint against us for breach of contract, fraud, and other claims. We plan to pursue our claims and rebuke the counter-claims vigorously, however, it is not possible at this time to estimate the outcome of this matter. As of March 31, 2007, no amounts have been recorded in the consolidated financial statements for this matter as management believes an unfavorable outcome is not probable.

We are not currently involved in any other material legal proceedings. From time to time, however, we may become subject to additional legal proceedings, claims, and litigation arising in the ordinary course of business, including, but not limited to, employee, customer and vendor disputes. In addition, in the past we have received, and we may continue to receive in the future, letters alleging infringement of patent or other intellectual property rights. Our management believes that these letters generally are without merit and we intend to contest them vigorously.

**ITEM 1A. RISK FACTORS**

*This Report contains forward-looking statements based on the current expectations, assumptions, estimates and projections about our industry and us. These forward-looking statements involve risks and uncertainties. Our actual results could differ materially from those discussed in these forward-looking statements as a result of certain factors, as more fully described in this section and elsewhere in this Report. You should carefully consider the following risks before you decide to buy shares of our common stock. The risks and uncertainties described below are not the only ones facing us. Additional risks and uncertainties, including those risks set forth in Management's Discussion and Analysis of Financial Condition and Results of Operations below, may also adversely impact and impair our business. If any of the following risks actually occur, our business, results of operations or financial condition would likely suffer. In such case, the trading price of our common stock could decline, and you may lose all or part of the money you paid to buy our stock. We do not undertake to update publicly any forward-looking statements for any reason, even if new information becomes available or other events occur in the future.*

**We expect our quarterly operating results to fluctuate in future periods, causing our stock price to fluctuate or decline.**

Our quarterly operating results have fluctuated in the past, and we believe they will continue to do so in the future. Our future results of operations will depend on many factors including:

Our suppliers' production levels for the components used in our products;

Our ability to procure required components;

Fluctuations in the cost of components and changes in the average sales prices of our products;

Changes in our customer and product revenue mix;

Our ability to successfully integrate any acquired businesses or assets;

Market acceptance of new and enhanced versions of our products;

Expansion of our international business, including the opening of offices and facilities in foreign countries;

The timing of the introduction of new products or components and enhancements to existing products or components by us, our competitors or our suppliers;

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Order cancellations, product returns, inventory buildups by customers and inventory write-downs;

Manufacturing inefficiencies associated with the start-up of new products and volume production;

Expenses associated with strategic transactions, including acquisitions, joint ventures and capital investments;

Our ability to adequately support potential future rapid growth;

Our ability to absorb manufacturing overhead if revenues decline;

The effects of litigation;

Increases in our sales and marketing expenses in connection with decisions to pursue new product initiatives; and

Expenses associated with the start-up of new operations or divisions.

Due to the above and other factors, quarterly revenues and results of operations are difficult to forecast, and period-to-period comparisons of our operating results may not be predictive of future performance. In one or more future quarters, our results of operations may fall below the expectations of securities analysts and investors. In that event, the trading price of our common stock would likely decline. In addition, the trading price of our common stock may fluctuate or decline regardless of our operating performance.



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**We have a less diversified customer base and our future success will be dependent on our ability to grow our OEM business.**

Prior to the divestiture of our Consumer Division in February 2007, we offered memory and external hard drive storage solutions through our Consumer Division to retail customers and OEM Division to OEM customers. We are now focused on, and expect to spend significant resources to grow, our business in the OEM market for customized memory solutions based on Flash memory and DRAM technologies. As a result of the divestiture of our Consumer Division, we have a less diversified customer base and our future success will be dependent on our ability to grow our OEM business. In addition, our focus on a single market—the OEM market—means that the seasonality and cyclicality of this market will have a greater impact on our operations and revenues than in previous years when we concentrated on the consumer and OEM markets. There can be no assurance that our focus on the OEM market will be successful or that the resources we commit to grow our OEM business will result in future profitability or market acceptance of our business or products. Our failure to grow our OEM business will harm our reputation and have a material adverse effect on our business, financial condition and results of operations.

**Our dependence on a small number of suppliers for integrated circuit, or IC, devices and inability to obtain a sufficient supply of these components on a timely basis could harm our ability to fulfill orders.**

Typically, IC devices represent more than 80% of the component costs of our manufactured Flash products and DRAM modules. We are dependent on a small number of suppliers that supply key components used in the manufacture of our products. We have no long-term supply contracts. Some of our competitors have entered into long-term contracts with suppliers that guarantee them a certain allocation of components, such as Flash IC devices. We have no assurance that our existing suppliers will agree to supply the quantities of components we may need to meet our production goals. We periodically review opportunities to develop alternative sources for our Flash and DRAM IC device needs. However, our options are very limited because of the small number of memory manufacturers. Samsung currently supplies substantially all of the IC devices used in our Flash memory products. Micron, Qimonda and Samsung currently supply substantially all of the DRAM IC devices used in our DRAM and IC Tower stacking DRAM memory products. Our dependence on a small number of suppliers and the lack of any guaranteed sources of supply expose us to several risks, including the inability to obtain an adequate supply of components, price increases, late deliveries and poor component quality. A disruption in or termination of our supply relationship with any of these significant suppliers due to natural disasters or other factors, or our inability to develop relationships with new suppliers, if required, would cause delays, disruptions or reductions in product shipments or require product redesigns which could damage relationships with our customers and negatively affect our revenues and could increase our costs or the prices of our products. In particular, if our supply relationships with Micron, Qimonda and Samsung are disrupted or terminated, our ability to manufacture and sell our products would be harmed and our business would be adversely affected.

Moreover, from time to time, our industry experiences shortages in Flash and DRAM IC devices which have driven up the price of those components and required some vendors to place their customers, ourselves included, on component allocation. This means that while we may have customer orders, we may not be able to obtain the materials that we need to fill those orders in a timely manner or at competitive prices. If we are unable to obtain Flash and DRAM IC devices at economical prices, our gross margins would decline unless we could raise the prices of our products in a commensurate manner or offset the cost increases elsewhere. In addition, if we are unable to obtain sufficient Flash IC devices and other components to meet our customers' requirements, they may reduce future orders or eliminate us as a supplier and our revenues may decline. As a result, our reputation could be harmed, we may not be able to replace any lost business with new customers, and we may lose market share to our competitors.

**Ineffective management of inventory levels or product mix, order cancellations, product returns, and inventory write-downs could adversely affect our results of operations.**

If we are unable to properly monitor, control and manage our inventory and maintain an appropriate level and mix of products with our customers, we may incur increased and unexpected costs associated with this inventory. For example, if we manufacture products in anticipation of future demand that does not materialize, or if a customer cancels outstanding orders, we could experience an unanticipated increase in our inventory that we may be unable to sell in a timely manner, if at all. As a result, we could incur increased expenses associated with writing off excess or obsolete inventory. In addition, while we may not be contractually obligated to accept returned products, we may determine that it is in our best interest to accept returns in order to maintain good relations with our customers. Product returns would increase our inventory and reduce our revenues. Alternatively, we could end up with too little inventory and we may not be able to satisfy demand, which could have a material adverse effect on our customer relationships. Our risks related to inventory management are exacerbated by our strategy of closely matching inventory levels with product demand, leaving limited margin for error. We have had to write-down inventory in the past for reasons such as obsolescence, excess quantities and declines in market value below our costs.

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We have no long-term volume commitments from our customers. Sales of our products are made through individual purchase orders and, in certain cases, are made under master agreements governing the terms and conditions of the relationships.

Customers may change, cancel or delay orders with limited or no penalties. We have experienced cancellations of orders and fluctuations in order levels from period-to-period and we expect to continue to experience similar cancellations and fluctuations in the future, which could result in fluctuations in our revenues.

**Declines in our average sales prices may result in declines in our revenues and gross profit.**

Our industry is competitive and characterized by historical declines in average sales prices. Our average sales prices may decline due to several factors. From time to time, overcapacity in the DRAM and Flash memory component markets have resulted in significant declines in component prices, which has negatively impacted our average sales prices, revenues and gross profit. During periods of overcapacity, our revenues and gross profit will decline if we do not increase unit sales of existing products or fail to introduce and sell new products in quantities sufficient to offset declines in sales prices. Any efforts to reduce costs and develop new products to offset the impact of further declines in average sales prices may not be successful. Our competitors and customers also impose significant pricing pressures on us. Since a large percentage of our sales are to a small number of customers that are primarily distributors and large OEMs, these customers have exerted, and we expect they will continue to exert, pressure on us to make price concessions.

In addition, the continued transition to smaller design geometries and the use of 300 millimeter wafers by existing memory manufacturers could lead to a significant increase in the worldwide supply of DRAM and Flash components. Increases in the worldwide supply of DRAM and Flash components could also result from manufacturing capacity expansions. If not offset by increases in demand, these increases would likely lead to further declines in the average sales prices of our products and have a material adverse effect on our business and operating results. Furthermore, even if supply remains constant, if demand were to decrease, it would harm our average sales prices.

**We are subject to the cyclical nature of the semiconductor industry and any future downturn could adversely affect our business.**

The semiconductor industry, including the memory markets in which we compete, is highly cyclical and characterized by constant and rapid technological change, rapid product obsolescence and price erosion, evolving standards, short product life cycles and wide fluctuations in product supply and demand. The industry has experienced significant downturns often connected with, or in anticipation of, maturing product cycles of both semiconductor companies and their customers products and declines in general economic conditions. These downturns have been characterized by diminished product demand, production overcapacity, high inventory levels and accelerated erosion of average sales prices. Prior downturns in the semiconductor industry negatively impacted our average sales prices, revenues and earnings. Any future downturns could have a material adverse effect on our business and results of operations.

**Sales to a limited number of customers represent a significant portion of our revenues, and the loss of any key customer would materially reduce our revenues.**

Our dependence on a limited number of customers means that the loss of a major customer or any reduction in orders by a major customer would materially reduce our revenues. We have no long-term contracts with our customers. Historically, a relatively limited number of customers have accounted for a significant percentage of our revenues. We expect that the divestiture of our Consumer Division in February 2007 will not change our future dependence on a limited number of customers for a significant portion of our revenues and, in fact, may exacerbate our dependence since all of our revenues will be derived from our OEM Division. Our ten largest customers accounted for an aggregate of 73.5% and 78.8% of our revenues in the three months ended March 31, 2007 and 2006, respectively. The following table sets forth certain information about each of our customers that accounted for more than 10.0% of our revenues in any of the three months ended March 31, 2007 and 2006.

|                      | Percentage of Revenues<br>for the Three Months Ended<br>March 31, |      |
|----------------------|---|------|
|                      | 2007  | 2006 |
| Smart Modular        | 53%   | 36%  |
| Micron Semiconductor | *   | 24%  |

\* Less than 10%



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Consolidation in some of our customers' industries may result in increased customer concentration and the potential loss of customers as a result of acquisitions. In addition, the composition of our major customer base changes from quarter to quarter as the market demand for our customers' products changes, and we expect this variability to continue in the future. We expect that sales of our products to a limited number of customers will continue to contribute materially to our revenues in the foreseeable future. The loss of, or a significant reduction in purchases by any of our major customers, could harm our business, financial condition and results of operations.

### **We may be less competitive if we fail to develop new and enhanced products and introduce them in a timely manner.**

The memory, high-performance computing, networking and communications, and OEM markets are subject to rapid technological change, product obsolescence, frequent new product introductions and enhancements, changes in end-user requirements and evolving industry standards. Our ability to compete in these markets will depend in significant part upon our ability to successfully develop, introduce and sell new and enhanced products on a timely and cost-effective basis, and to respond to changing customer requirements.

We have experienced, and may in the future experience, delays in the development and introduction of new products. These delays would provide a competitor a first-to-market opportunity and allow a competitor to achieve greater market share. Our product development is inherently risky because it is difficult to foresee developments in technology, anticipate the adoption of new standards, coordinate our technical personnel, and identify and eliminate design flaws. Defects or errors found in our products after commencement of commercial shipments could result in delays in market acceptance of these products. New products, even if first introduced by us, may not gain market acceptance. Accordingly, there can be no assurance that our future product development efforts will result in future profitability or market acceptance. Lack of market acceptance for our new products will jeopardize our ability to recoup research and development expenditures, hurt our reputation and harm our business, financial condition and results of operations.

We may also seek to develop products with new standards for our industry. It will take time for these new standards and products to be adopted, for consumers to accept and transition to these new products and for significant sales to be generated from them, if this happens at all. Moreover, broad acceptance of new standards or products by consumers may reduce demand for our older products. If this decreased demand is not offset by increased demand for our new products, our results of operations could be harmed. We cannot assure you that any new products or standards we develop will be commercially successful.

### **Our efforts to expand our business internationally may not be successful and may expose us to additional risks that may not exist in the United States, which in turn could cause our business and operating results to suffer.**

We sell our products to customers in foreign countries and seek to increase our level of international business activity through the expansion of our operations into select international markets, including Asia and Europe. Such strategy may include opening sales offices in foreign countries, the outsourcing of manufacturing operations to third party contract manufacturers, establishing joint ventures with foreign partners, and the establishment of manufacturing operations in foreign countries. Since the beginning of 2004, we have opened sales, marketing, procurement and engineering offices in Austria, France, Hong Kong, Japan, Malaysia, the Netherlands, Taiwan and the United Kingdom. In addition, we are building a 200,000 square foot manufacturing facility in Malaysia that is expected to be operational in the first quarter of 2008.

Establishing operations in any other foreign country or region presents numerous risks, including:

foreign laws and regulations, which may vary country by country, may impact how we conduct our business;

higher costs of doing business in certain foreign countries, including different employment laws;

difficulty protecting our intellectual property rights from misappropriation or infringement;

difficulties and costs of staffing and managing operations in certain foreign countries;

political or economic instability;

changes in import/export duties;

necessity of obtaining government approvals;

trade restrictions;

work stoppages or other changes in labor conditions;

difficulties in collecting of accounts receivables on a timely basis or at all;

taxes;

longer payment cycles and foreign currency fluctuations; and

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seasonal reductions in business activity in some parts of the world, such as Europe.

In addition, changes in policies and/or laws of the United States or foreign governments resulting in, among other things, higher taxation, currency conversion limitations, restrictions on fund transfers or the expropriation of private enterprises, could reduce the anticipated benefits of our international expansion. We may also encounter potential adverse tax consequences if taxing authorities in different jurisdictions worldwide disagree with our interpretation of various tax laws or our determinations as to the income and expenses attributable to specific jurisdictions, which could result in our paying additional taxes, interest and penalties. Furthermore, any actions by countries in which we conduct business to reverse policies that encourage foreign trade or investment could adversely affect our business. If we fail to realize the anticipated revenue growth of our future international operations, our business and operating results could suffer.

We expect that our strategy to expand our international operations will require the expenditure of significant resources and involve the efforts and attention of our management. Unlike some of our competitors, we have limited experience operating our business in foreign countries. Some of our competitors may have substantial advantage over us in attracting customers in certain foreign countries due to earlier established operations in that country, greater knowledge with respect to cultural differences of customers residing in that country and greater brand recognition and longer-standing relationships with customers in that country. If our international expansion efforts in any foreign country are unsuccessful, we may decide to cease these foreign operations, which would likely harm our reputation and cause us to incur expenses and losses.

### **Failure to maintain effective internal control over financial reporting could result in a negative market reaction.**

Section 404 of the Sarbanes-Oxley Act of 2002 requires that we undertake a thorough examination of our internal control systems and procedures for financial reporting. We also are required to completely document and test those systems. Ultimately, our management will be responsible for assessing the effectiveness of our internal control over financial reporting, and our independent registered public accounting firm will be requested to attest to that report. We cannot be certain as to the timing of completion of our evaluation, testing and remediation actions or the impact of the same on our operations since there is no precedent available by which to measure compliance adequacy.

Our filing of our annual report on a timely basis will depend upon our timely completion of these tasks. A late annual report could have material adverse effects on us, both legally and with respect to the opinions of the participants in the securities market.

If we identify one or more material weaknesses in our internal control over financial reporting, our management will be unable to assert such internal controls are effective. If we are unable to assert that our internal controls over financial reporting are effective, or if our independent registered public accounting firm is unable to attest that our management's report is fairly stated or they are unable to express an opinion on the effectiveness of our internal controls, it could result in a negative market reaction. At the present time the Company is not an accelerated filer and is not subject to Section 404 of the Sarbanes-Oxley Act of 2002.

### **Compliance with changing regulation of corporate governance and public disclosure may result in additional expenses.**

Changing laws, regulations and standards relating to corporate governance and public disclosure, including the Sarbanes-Oxley Act of 2002, new SEC regulations and Nasdaq rules, have required most public companies, including us, to devote additional internal and external resources to various governance and compliance matters. Because we have a relatively small corporate staff, we rely heavily on outside professional advisers to assist us with these efforts. Although we are uncertain about the total costs we will incur in connection with these efforts, we know they will at least be substantial.

These costs will include increased accounting related fees associated with preparing the attestation report on our internal controls over financial reporting as required under Section 404 of the Sarbanes-Oxley Act of 2002. These new or changed laws, regulations and standards are subject to varying interpretations, as well as modifications by the government and Nasdaq. The way in which they are applied and implemented may change over time, which could result in even higher costs to address and implement revisions to compliance (including disclosure) and governance practices. We intend to invest the necessary resources to comply with evolving laws, regulations and standards. If our efforts to comply with new or changed laws, regulations and standards differ from the activities intended by regulatory or governing bodies due to ambiguities related to practice, our reputation may be harmed and we will be required to incur additional expenses.

### **We may make acquisitions that are dilutive to existing shareholders, result in unanticipated accounting charges or otherwise adversely affect our results of operations.**

We intend to grow our business through business combinations or other acquisitions of businesses, products or technologies that allow us to complement our existing product offerings, expand our market coverage, increase our engineering workforce or enhance our technological capabilities. If we make any future acquisitions, we could issue stock that would dilute our shareholders' percentage ownership, incur substantial

debt, reduce our cash reserves or assume contingent liabilities.

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Furthermore, acquisitions may require material infrequent charges and could result in adverse tax consequences, substantial depreciation, deferred compensation charges, in-process research and development charges, the amortization of amounts related to deferred compensation and identifiable purchased intangible assets or impairment of goodwill, any of which could negatively impact our results of operations.

### **Our limited experience in acquiring other businesses, product lines and technologies may make it difficult for us to overcome problems encountered in connection with any acquisitions we may undertake.**

We continually evaluate and explore strategic opportunities as they arise, including business combinations, strategic partnerships, capital investments and the purchase, licensing or sale of assets. Our experience in acquiring other businesses, product lines and technologies is limited. The attention of our small management team may be diverted from our core business if we undertake any future acquisitions. Our recent acquisition of Memtech, SSD Corporation, the assets of a division of Integrated Circuit Solution Incorporation, the assets of Gnutek Ltd. and any potential future acquisitions also involve numerous risks, including, among others:

Problems and delays in successfully assimilating and integrating the purchased operations, personnel, technologies, products and information systems;

Unanticipated costs and expenditures associated with the acquisition, including any need to infuse significant capital into the acquired operations;

Adverse effects on existing business relationships with suppliers, customers and strategic partners;

Risks associated with entering markets and foreign countries in which we have no or limited prior experience;

Contractual, intellectual property or employment issues;

Potential loss of key employees of purchased organizations; and

Potential litigation arising from the acquired company's operations before the acquisition.

These risks could disrupt our ongoing business, distract our management and employees, harm our reputation and increase our expenses. Our inability to overcome problems encountered in connection with any acquisitions could divert the attention of management, utilize scarce corporate resources and otherwise harm our business. These challenges are magnified as the size of an acquisition increases, and we cannot assure you that we will realize the intended benefits of any acquisition. For example, in June 2004 we discontinued the operation of our Xiran Division, which was formed in 2002 as a result of our acquisition of the assets of Irvine Networks, LLC. The Xiran Division developed advanced board-level solutions that optimize server performance for networked storage applications, including IP storage. We were unable to successfully bring the Xiran Division products to market after funding its operations for over two years. In connection with the discontinued operation, we recorded a one-time charge of approximately \$3.0 million in the second quarter of 2004.

We are unable to predict whether or when any prospective acquisition candidate will become available or the likelihood that any acquisition will be completed. Even if we do find suitable acquisition opportunities, we may not be able to consummate the acquisitions on commercially acceptable terms or realize the anticipated benefits of any acquisitions we do undertake.

### **Three of our beneficial shareholders have substantial influence over our operations and could control all matters requiring shareholder approval.**

Our founders, Manouch Moshayedi, Mike Moshayedi and Mark Moshayedi, are brothers and beneficially own approximately 50% of our outstanding common stock at March 31, 2007 (assuming the inclusion of shares of common stock subject to options that are presently



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exercisable or will become exercisable within 60 days of such date). In addition, Manouch Moshayedi and Mark Moshayedi are executive officers and directors. As a result, they potentially have the ability to control or influence all matters requiring approval by our shareholders, including the election and removal of directors, approval of significant corporate transactions and the decision of whether a change in control will occur. This potential control could affect the price that certain investors may be willing to pay in the future for shares of our common stock.

### **We are involved from time to time in claims and litigation over intellectual property rights, which may adversely affect our ability to manufacture and sell our products.**

The semiconductor industry is characterized by vigorous protection and pursuit of intellectual property rights. We believe that it may be necessary, from time to time, to initiate litigation against one or more third parties to preserve our intellectual property rights. Some of our suppliers and licensors have generally agreed to provide us with various levels of intellectual property indemnification for products and technology we purchase or license from them. A third-party could claim that our products, which incorporate the products purchased or technology licensed from our suppliers and licensors, infringes a

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patent or other proprietary right. In addition, from time to time, we have received, and may continue to receive in the future, notices that claim we have infringed upon, misappropriated or misused other parties' proprietary rights. Any of the foregoing events or claims could result in litigation. Such litigation, whether as plaintiff or defendant, would likely result in significant expense to us and divert the efforts of our technical and management personnel, whether or not such litigation is ultimately determined in our favor. In the event of an adverse result in such litigation, we could be required to pay substantial damages, cease the manufacture, use and sale of certain products, expend significant resources to develop non-infringing technology, discontinue the use of certain processes or obtain licenses to use the infringed technology. In addition, our suppliers' and licensors' obligation to indemnify us for intellectual property infringement may be insufficient or inapplicable to any such litigation. A license may not be available on commercially reasonable terms, if at all. Our failure to obtain a license on commercially reasonable terms, or at all, could cause us to incur substantial costs and suspend manufacturing products using the infringed technology. If we obtain a license, we would likely be required to pay license fees or make royalty payments for sales under the license. Such payments would increase our costs of revenues and reduce our gross margins and gross profit. If we are unable to obtain a license from a third party for technology, we could incur substantial liabilities or be required to expend substantial resources redesigning our products to eliminate the infringement. There can be no assurance that we would be successful in redesigning our products or that we could obtain licenses on commercially reasonable terms, if at all. Product development or license negotiating would likely result in significant expense to us and divert the efforts of our technical and management personnel.

We are currently a party to one lawsuit regarding intellectual property as further described under Legal Proceedings. Because litigation is inherently uncertain, we cannot predict the outcome of this lawsuit. Although this lawsuit has been stayed pending the outcome of related lawsuits against other parties, we expect that if this lawsuit resumes, it is likely to divert the efforts and attention of our key management and technical personnel. In addition, we expect to incur substantial legal fees and expenses in connection with this lawsuit if it resumes. As a result, our defense of this lawsuit, regardless of its eventual outcome, is expected to be costly and time consuming.

**To manage our growth, we may need to improve our systems, controls and procedures and relocate portions of our business to new or larger facilities.**

We have experienced and may continue to experience rapid growth, which has placed, and could continue to place a significant strain on our managerial, financial and operations resources and personnel. We expect that our number of employees, including management-level employees, will continue to increase for the foreseeable future. We must continue to improve our operational, accounting and financial systems and managerial controls and procedures, including fraud procedures, and we will need to continue to expand, as well as, train and manage our workforce. From time to time, we may need to relocate portions of our business to new or larger facilities which could result in disruption of our business or operations. For example, we announced in August 2006 plans to build a 200,000 square foot manufacturing facility in Malaysia that is expected to be operational in the first quarter of 2008. If we do not manage our growth effectively, including transitions to new or larger facilities, our business could be harmed.

**Our indemnification obligations for the infringement by our products of the intellectual property rights of others could require us to pay substantial damages.**

As is common in the industry, we currently have in effect a number of agreements in which we have agreed to defend, indemnify and hold harmless our customers and suppliers from damages and costs which may arise from the infringement by our products of third-party patents, trademarks or other proprietary rights. The scope of such indemnity varies, but may, in some instances, include indemnification for damages and expenses, including attorneys' fees. Our insurance does not cover intellectual property infringement. The term of these indemnification agreements is generally perpetual any time after execution of the agreement. The maximum potential amount of future payments we could be required to make under these indemnification agreements is unlimited. We may periodically have to respond to claims and litigate these types of indemnification obligations. Any such indemnification claims could require us to pay substantial damages.

**Our indemnification obligations to our customers and suppliers for product defects could require us to pay substantial damages.**

A number of our product sales and product purchase agreements provide that we will defend, indemnify and hold harmless our customers and suppliers from damages and costs which may arise from product warranty claims or claims for injury or damage resulting from defects in our products. We maintain insurance to protect against certain claims associated with the use of our products, but our insurance coverage may not be adequate to cover all or any part of the claims asserted against us. A successful claim brought against us that is in excess of, or excluded from, our insurance coverage could substantially harm our business, financial condition and results of operations.

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### **Our intellectual property may not be adequately protected, which could harm our competitive position.**

Our intellectual property is critical to our success. We protect our intellectual property rights through patents, trademarks, copyrights and trade secret laws, confidentiality procedures and employee disclosure and invention assignment agreements. It is possible that our efforts to protect our intellectual property rights may not:

Prevent the challenge, invalidation or circumvention of our existing patents;

Result in patents that lead to commercially viable products or provide competitive advantages for our products;

Prevent our competitors from independently developing similar products, duplicating our products or designing around the patents owned by us;

Prevent third-party patents from having an adverse effect on our ability to do business;

Provide adequate protection for our intellectual property rights;

Prevent disputes with third parties regarding ownership of our intellectual property rights;

Prevent disclosure of our trade secrets and know-how to third parties or into the public domain; and

Result in patents from any of our pending applications.

As part of our confidentiality procedures, we enter into non-disclosure and invention assignment agreements with all of our employees and attempt to control access to and distribution of our technology, documentation and other proprietary information. However, if such agreements are found to be unenforceable, we may be unable to adequately protect our intellectual property rights. In addition, despite these procedures, third parties could copy or otherwise obtain and make unauthorized use of our technologies or independently develop similar technologies.

In addition, if our IC Tower stacking patent is found to be invalid, our ability to exclude competitors from making, using or selling the same or similar products to our IC Tower stacking products would cease. We have on at least one occasion applied for and may in the future apply for patent protection in foreign countries. The laws of foreign countries, however, may not adequately protect our intellectual property rights. Many U.S. companies have encountered substantial infringement problems in foreign countries. Because we sell some of our products overseas, we have exposure to foreign intellectual property risks.

### **We may not be able to maintain or improve our competitive position because of the intense competition in the memory industry.**

We conduct business in an industry characterized by intense competition, rapid technological change, evolving industry standards, declining average sales prices and rapid product obsolescence. Our primary competitors in the third-party memory industry include: Crucial Memory, a division of Micron Technology, Netlist, Wintec, SMART Modular, SanDisk, ST Micro and Viking Interworks. Our competitors include many large domestic and international companies that have substantially greater financial, technical, marketing, distribution and other resources, broader product lines, lower cost structures, greater brand recognition and longer-standing relationships with customers and suppliers. As a result, our competitors may be able to respond better to new or emerging technologies or standards and to changes in customer requirements. Further, some of our competitors are in a better financial and marketing position from which to influence industry acceptance of a particular industry standard or competing technology than we are. Our competitors may also be able to devote greater resources to the development, promotion and sale of products, and may be able to deliver competitive products at a lower price.

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We expect to face competition from existing competitors and new and emerging companies that may enter our existing or future markets with similar or alternative products, which may be less costly or provide additional features. In addition, some of our significant suppliers, including Micron, Qimonda and Samsung Semiconductor, are also our competitors, many of whom have the ability to manufacture competitive products at lower costs as a result of their higher levels of integration. We also face competition from current and prospective customers that evaluate our capabilities against the merits of manufacturing products internally. Competition may arise due to the development of cooperative relationships among our current and potential competitors or third parties to increase the ability of their products to address the needs of our prospective customers. Accordingly, it is possible that new competitors or alliances among competitors may emerge and rapidly acquire significant market share.

We expect our competitors will continue to improve the performance of their current products, reduce their prices and introduce new products that may offer greater performance and improved pricing, any of which could cause a decline in sales or loss of market acceptance of our products. In addition, our competitors may develop enhancements to, or future generations of, competitive products that may render our technology or products obsolete or uncompetitive.

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### **The manufacturing of our products is complex and subject to yield problems, which could decrease available supply and increase costs.**

The manufacture of our Flash memory products, stacked DRAM products and Flash controllers is a complex process, and it is often difficult for companies to achieve acceptable product yields. Reduced yields could decrease available supply and increase costs. Flash controller yields depend on both our product design and the manufacturing process technology unique to our semiconductor foundry partners. Because low yields may result from either design defects or process difficulties, we may not identify yield problems until well into the production cycle, when an actual product defect exists and can be analyzed and tested. In addition, many of these yield problems are difficult to diagnose and time consuming or expensive to remedy.

### **The execution of our growth strategy depends on our ability to retain key personnel, including our executive officers, and to attract qualified personnel.**

Competition for employees in our industry is intense. We have had and may continue to have difficulty hiring the necessary engineering, sales and marketing and management personnel to support our growth. The successful implementation of our business model and growth strategy depends on the continued contributions of our senior management and other key research and development, sales and marketing and operations personnel, including Manouch Moshayedi, our Chief Executive Officer, Mark Moshayedi, our President, Chief Operating Officer, Chief Technical Officer and Secretary, and Dan Moses, our Executive Vice President and Chief Financial Officer. In addition, as a result of our adoption of Statement of Financial Accounting Standards ( SFAS ) 123(R), Share-Based Payment, we have begun to significantly reduce the use and quantity of stock options compared to the quantity of stock options we granted in recent years. We may be at a disadvantage in our ability to maintain and recruit qualified employees since many of the companies that compete with us for the same pool of qualified employees continue to offer stock options as part of their compensation package. We have experienced difficulties maintaining and attracting qualified employees as a result of our reduction in the use of stock options and we expect this difficulty to continue in the future unless we are able to develop other forms of incentive compensation to replace stock options. The loss of any key employee, the failure of any key employee to perform in his or her current position, or the inability of our officers and key employees to expand, train and manage our employee base would prevent us from executing our growth strategy.

### **We face risks associated with doing business in foreign countries, including foreign currency fluctuations and trade barriers, that could lead to a decrease in demand for our products or an increase in the cost of the components used in our products.**

The volatility of general economic conditions and fluctuations in currency exchange rates affect the prices of our products and the prices of the components used in our products. International sales of our products accounted for 20.8% and 11.7% of our revenues for the three months ended March 31, 2007 and 2006, respectively. No foreign geographic area or single foreign country accounted for more than 10.0% of our revenues in each of the three months ended March 31, 2007 and 2006. For the three months ended March 31, 2007 and 2006, more than 95.0% of our international sales were denominated in U.S. dollars. However, if there is a significant devaluation of the currency in a specific country, the prices of our products will increase relative to that country's currency and our products may be less competitive in that country. In addition, we cannot be sure that our international customers will continue to be willing to place orders denominated in U.S. dollars. If they do not, our revenues and results of operations will be subject to foreign exchange fluctuations, which could harm our business. We do not hedge against foreign currency exchange rate risks.

We purchase a majority of the DRAM and Flash components used in our products from local distributors of foreign suppliers. Although our purchases of DRAM and Flash components are currently denominated in U.S. dollars, devaluation of the U.S. dollar relative to the currency of a foreign supplier would likely result in an increase in our cost of DRAM and Flash components.

Our international sales are subject to other risks, including regulatory risks, tariffs and other trade barriers, timing and availability of export licenses, political and economic instability, difficulties in accounts receivable collections, difficulties in managing distributors, lack of a significant local sales presence, difficulties in obtaining governmental approvals, compliance with a wide variety of complex foreign laws and treaties and potentially adverse tax consequences. In addition, the United States or foreign countries may implement quotas, duties, taxes or other charges or restrictions upon the importation or exportation of our products, leading to a reduction in sales and profitability in that country.

### **We have experienced quarterly and annual losses in the past and may experience losses in the future.**

Although we have been profitable for most of our history, we have experienced losses on a quarterly and annual basis in the past. In 2003 and in the second quarter of 2004, we incurred net losses of \$1.6 million and \$1.9 million, respectively. We have expended, and will continue to expend, substantial funds to pursue engineering, research and development projects, enhance sales and marketing efforts, expand our international operations and increase our manufacturing capacity, and otherwise operate our business. There can be no assurance that we will be profitable on a quarterly or annual basis in the future.



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**Disruption of our operations in our Santa Ana, California, manufacturing facility would substantially harm our business.**

Substantially all of our manufacturing operations are located in our facilities in Santa Ana, California. Due to this geographic concentration, a disruption of our manufacturing operations, resulting from sustained process abnormalities, human error, government intervention or natural disasters, including earthquakes, power failures, fires or floods, could cause us to cease or limit our manufacturing operations and consequently harm our business, financial condition and results of operations.

**Compliance with environmental laws and regulations could harm our operating results.**

We are subject to a variety of environmental laws and regulations governing, among other things, air emissions, waste water discharge, waste storage, treatment and disposal, and remediation of releases of hazardous materials. Our failure to comply with present and future requirements could harm our ability to continue manufacturing our products. Such requirements could require us to acquire costly equipment or to incur other significant expenses to comply with environmental regulations. The imposition of additional or more stringent environmental requirements, the results of future testing at our facilities, or a determination that we are potentially responsible for remediation at other sites where problems are not presently known to us, could result in expenses in excess of amounts currently estimated to be required for such matters.

**Failure to comply with governmental laws and regulations could harm our business.**

Our business is subject to regulation by various federal and state governmental agencies. Such regulation includes the radio frequency emission regulatory activities of the Federal Communications Commission, the anti-trust regulatory activities of the Federal Trade Commission and Department of Justice, the consumer protection laws of the Federal Trade Commission, the import/export regulatory activities of the Department of Commerce, the product safety regulatory activities of the Consumer Products Safety Commission, the regulatory activities of the Occupational Safety and Health Administration, the environmental regulatory activities of the Environmental Protection Agency, the labor regulatory activities of the Equal Employment Opportunity Commission and tax and other regulations by a variety of regulatory authorities in each of the areas in which we conduct business. We are also subject to regulation in other countries where we conduct business. In certain jurisdictions, such regulatory requirements may be more stringent than in the United States. We are also subject to a variety of federal and state employment and labor laws and regulations, including the Americans with Disabilities Act, the Federal Fair Labor Standards Act, the WARN Act and other regulations related to working conditions, wage-hour pay, over-time pay, employee benefits, anti-discrimination, and termination of employment.

Noncompliance with applicable regulations or requirements could subject us to investigations, sanctions, mandatory product recalls, enforcement actions, disgorgement of profits, fines, damages, civil and criminal penalties, or injunctions. In addition from time to time we have received, and expect to continue to receive, correspondence from former employees terminated by us who threaten to bring claims against us alleging that we have violated one or more labor and employment regulations. In certain of these instances the former employee has brought claims against us and we expect that we will encounter similar actions against us in the future. An adverse outcome in any such litigation could require us to pay contractual damages, compensatory damages, punitive damages, attorneys' fees and costs.

These enforcement actions could harm our business, financial condition, results of operations and cash flows. If any governmental sanctions are imposed, or if we do not prevail in any possible civil or criminal litigation, our business, financial condition, results of operations and cash flows could be materially adversely affected. In addition, responding to any action will likely result in a significant diversion of management's attention and resources and an increase in professional fees.

**Our stock price is likely to be volatile and could drop unexpectedly.**

Our common stock has been publicly traded only since September 2000. The market price of our common stock has been subject to significant fluctuations since the date of our initial public offering. The stock market has from time to time experienced significant price and volume fluctuations that have affected the market prices of securities, particularly securities of technology companies. As a result, the market price of our common stock may materially decline, regardless of our operating performance. In the past, following periods of volatility in the market price of a particular company's securities, securities class action litigation has often been brought against that company. We may become involved in this type of litigation in the future. Litigation of this type is often expensive and diverts management's attention and resources.

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### **Anti-takeover provisions in our charter documents and stock option plan could prevent or delay a change in control and, as a result, negatively impact our shareholders.**

We have taken a number of actions that could have the effect of discouraging a takeover attempt. For example, provisions of our amended and restated articles of incorporation and amended and restated bylaws could make it more difficult for a third party to acquire us, even if doing so would be beneficial to our shareholders. These provisions also could limit the price that certain investors might be willing to pay in the future for shares of our common stock.

These provisions include:

limitations on who may call special meetings of shareholders;

advance notice requirements for nominations for election to the board of directors or for proposing matters that can be acted upon by shareholders at shareholder meetings;

elimination of cumulative voting in the election of directors;

the right of a majority of directors in office to fill vacancies on the board of directors;

the ability of our board of directors to issue, without shareholder approval, blank check preferred stock to increase the number of outstanding shares and thwart a takeover attempt.

Provisions of our 2000 Stock Incentive Plan allow for the automatic vesting of all outstanding options granted under the 2000 Stock Incentive Plan upon a change in control under certain circumstances. Such provisions may have the effect of discouraging a third party from acquiring us, even if doing so would be beneficial to our shareholders.

## **ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

### **Issuer Purchases of Equity Securities**

In July 2006, our board of directors authorized a share repurchase program enabling us to repurchase up to \$10 million of our common stock over an 18-month period expiring on February 14, 2008. We have not purchased any shares of our common stock under this share repurchase program.

## **ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

None.

## **ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

None.



**ITEM 5. OTHER INFORMATION**

None.

**ITEM 6. EXHIBITS**

**Exhibit**

| <b>Number</b> | <b>Description</b>  |
|---------------|---|
| 31.1          | Section 302 Certification of Chief Executive Officer  |
| 31.2          | Section 302 Certification of Chief Financial Officer  |
| 32.1*         | Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 32.2*         | Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |

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\* The information in Exhibits 32.1 and 32.2 shall not be deemed filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended (the Exchange Act), or otherwise subject to the liabilities of that section, nor shall they be deemed incorporated by reference in any filing under the Securities Act of 1933, as amended, or the Exchange Act (including this Report), unless STEC, Inc. specifically incorporates the foregoing information into those documents by reference.

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**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

STEC, INC.,

a California corporation

Date: May 15, 2007

/s/ DAN MOSES

Dan Moses

Chief Financial Officer (Principal Financial

Officer and Duly Authorized Signatory)

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**STEC, INC.**

**Index to Exhibits**

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