SILICON STORAGE TECHNOLOGY INC
Form 10-Q
August 07, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2006

OR

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

For the transition period from to .

Commission File Number 0-26944

SILICON STORAGE TECHNOLOGY, INC.

(Exact name of Registrant as Specified in its Charter)

California	**77-0225590**
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification Number)
1171 Sonora Court, Sunnyvale, CA	**94086**
(Address of Principal Executive Offices)	(Zip Code)

(408) 735-9110

(Registrant s Telephone Number, including Area Code)

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 x No o

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 file in Rule 12b-2 of the Exchange Act. (check one):

Large Accelerated filer o Accelerated filer x Non-accelerated filer o

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

Number of shares outstanding of our Common Stock, no par value, as of the latest practicable date, July 31, 2006: 103,198,374.

SILICON STORAGE TECHNOLOGY, INC.

FORM 10-Q: QUARTER ENDED JUNE 30, 2006
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Item 1. Condensed Consolidated Financial Statements (Unaudited)

SILICON STORAGE TECHNOLOGY, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)
(in thousands, except per share data)

	Three Months Ended June 30, 2005	2006	Six Months Ended June 30, 2005	2006
Net revenues:				
Product revenues - unrelated parties	$ 36,872	$ 40,775	$ 74,493	$ 78,807
Product revenues - related parties	48,010	58,163	89,659	120,434
Technology licensing	8,388	8,791	15,331	17,641
Technology licensing - related parties	29		131	1,378
Total net revenues	93,299	107,729	179,614	218,260
Cost of revenues:				
Cost of revenues - unrelated parties	33,268	29,259	65,709	57,074
Cost of revenues - related parties	48,769	51,096	90,050	99,899
Total cost of revenues	82,037	80,355	155,759	156,973
Gross profit	11,262	27,374	23,855	61,287
Operating expenses:				
Research and development	13,086	13,093	25,051	28,260
Sales and marketing	7,006	7,042	14,346	15,203
General and administrative	7,123	5,769	13,825	11,806
Other operating expenses	2,911		2,911	
Total operating expenses	30,126	25,904	56,133	55,269
Income (loss) from operations	(18,864)	1,470	(32,278)	6,018
Other income (expense), net	1,014	1,056	1,215	1,495
Interest expense	(37)	(57)	(58)	(136)
Gain on sale of equity investments				12,206
Impairment of equity investments				(3,523)
Income (loss) before provision for (benefit from) income taxes and minority interest	(17,887)	2,469	(31,121)	16,060
Provision for income taxes	1,693	1,014	2,440	3,315
Minority interest	7		(77)	
Net income (loss)	$ (19,587)	$ 1,455	$ (33,484)	$ 12,745
Net income (loss) per share - basic	$ (0.19)	$ 0.01	$ (0.33)	$ 0.12
Shares used in per share calculation - basic	102,201	103,178	100,010	103,159
Net income (loss) per share - diluted	$ (0.19)	$ 0.01	$ (0.33)	$ 0.12
Shares used in per share calculation - diluted	102,201	104,529	100,010	104,634

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

SILICON STORAGE TECHNOLOGY, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)
(in thousands)

	December 31, 2005	June 30, 2006
ASSETS		
Current assets:		
Cash and cash equivalents	$ 77,382	$ 87,798
Short-term available-for-sale investments	1,008	28,371
Trade accounts receivable-unrelated parties, net of allowance for doubtful accounts of $758 at December 31, 2005 and $1,082 at June 30, 2006	21,378	21,356
Trade accounts receivable-related parties	55,858	37,969
Inventories	108,343	94,433
Other current assets	13,109	13,194
Total current assets	277,078	283,121
Property and equipment, net	19,415	17,675
Long-term available-for-sale investments	39,057	22,500
Equity investments, GSMC	83,150	83,150
Equity investments, others	12,962	12,636
Goodwill	29,637	29,637
Intangible assets, net	11,816	11,545
Other assets	4,722	7,098
Total assets	$ 477,837	$ 467,362
LIABILITIES		
Current liabilities:		
Notes payable, current portion	$ 39	$ 218
Borrowing under line of credit facility	3,000	3,000
Trade accounts payable-unrelated parties	48,660	32,340
Trade accounts payable-related parties	21,867	21,791
Accrued expenses and other liabilities	17,318	21,552
Deferred revenue	4,493	4,090
Total current liabilities	95,377	82,991
Other liabilities	2,627	1,880
Total liabilities	98,004	84,871
Commitments (Note 6) and Contingencies (Note 7)		
SHAREHOLDERS EQUITY		
Preferred stock, no par value:		
Authorized: 7,000 shares Series A Junior Participating Preferred Stock, no par value Designated: 450 shares Issued and outstanding: none		
Common stock, no par value:		
Authorized: 250,000 shares Issued and outstanding: 102,827 shares at December 31, 2005 and 103,193 shares at June 30, 2006	377,027	382,203
Accumulated other comprehensive income	31,780	16,517
Accumulated deficit	(28,974)	(16,229)
Total shareholders equity	379,833	382,491

Total liabilities and shareholders equity	$	477,837	$	467,362

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

SILICON STORAGE TECHNOLOGY, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)
(in thousands)

	Six Months Ended June 30, 2005	2006
Cash flows from operating activities:		
Net income (loss)	$ (33,484)	$ 12,745
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization	4,671	4,982
Purchased in process research and development	1,661	
Stock-based compensation expense		3,802
Provision (credits) for doubtful accounts receivable	57	323
Provision for sales returns	1,689	421
Provision for excess and obsolete inventories, write-down of inventories and adverse purchase commitments	23,678	8,446
Loss in equity interest	260	28
Impairment loss on equity investment		3,523
Gain on sale of equity investments		(12,206)
(Gain) loss on disposal of equipment	30	(6)
Minority interest	(77)	
Changes in operating assets and liabilities:		
Trade accounts receivable-unrelated parties	4,802	(739)
Trade accounts receivable-related parties	4,138	17,906
Inventories	(33,245)	5,017
Other current and non-current assets	3,196	(2,681)
Trade accounts payable-unrelated parties	(17,445)	(15,880)
Trade accounts payable-related parties	(4,017)	(76)
Accrued expenses and other liabilities	(4,040)	4,082
Deferred revenue	572	(403)
Net cash provided by (used in) operating activities	(47,554)	29,284
Cash flows from investing activities:		
Acquisitions, net of cash	(7,818)	
Investments in equity securities	(333)	(3,000)
Purchase of property and equipment	(2,617)	(2,359)
Proceeds from sale of equipment		9
Purchase of intellectual property license		(317)
Purchases of available-for-sale investments	(20,305)	(33,699)
Sales and maturities of available-for-sale and equity investments	85,687	19,820
Net cash provided by (used in) investing activities	54,614	(19,546)
Cash flows from financing activities:		
Debt repayments	(214)	(94)
Borrowing against line of credit	3,000	
Issuance of shares of common stock	1,668	1,374
Capital lease payments		(602)
Net cash provided by financing activities	4,454	678
Net increase in cash and cash equivalents	11,514	10,416
Cash and cash equivalents at beginning of period	35,365	77,382
Cash and cash equivalents at end of period	$ 46,879	$ 87,798

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

SILICON STORAGE TECHNOLOGY, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED):

1. Basis of Presentation

In the opinion of management, the accompanying unaudited condensed interim consolidated financial statements contain all adjustments, all of which are normal and recurring in nature, necessary to fairly state our financial position, results of operations and cash flows. The results of operations for the interim periods presented are not necessarily indicative of the results that may be expected for any future interim periods or for the full fiscal year. These interim financial statements should be read in conjunction with the consolidated financial statements in our Annual Report on Form 10-K for the year ended December 31, 2005.

The year-end balance sheet at December 31, 2005 was derived from audited financial statements, but does not include all disclosures required by U.S. generally accepted accounting principles. Please refer to the audited financial statements in our Annual Report on Form 10-K for the year ended December 31, 2005.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and the 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.

Stock Based Compensation

Effective January 1, 2006, we adopted the fair value recognition provisions of Financial Accounting Standards Board, or FASB, Statement of Financial Accounting Standards, or SFAS No. 123(R), *Share-Based Payments*, using the modified prospective application method. Under this transition method, compensation cost recognized in the three and six months ended June 30, 2006, includes the applicable amounts of:
(a) compensation cost of all stock-based payments granted prior to, but not yet vested as of January 1, 2006 (based on the grant-date fair value estimated in accordance with the original provisions of SFAS No. 123 and previously presented in the pro forma footnote disclosures), and
(b) compensation cost for all stock-based payments granted subsequent to January 1, 2006 (based on the grant-date fair value estimated in accordance with the new provisions of SFAS No. 123(R)). Results for prior periods have not been restated to reflect the adoption of SFAS No. 123(R).

Recent Accounting Pronouncements

In September 2005, the FASB ratified Emerging Issues Task Force Issue No. 04-13, *Accounting for Purchases and Sales of Inventory with the Same Counterparty*, or EITF 04-13. EITF 04-13 discusses whether inventory purchase and sales transactions with the same counterparty that are entered into in contemplation of one another should be combined and treated as a nonmonetary exchange and addresses (a) under what circumstances should two or more transactions with the same counterparty (counterparties) be viewed as a single nonmonetary transaction within the scope of APB Opinion No. 29, *Accounting for Nonmonetary Transactions*, or APB 29, and Financial Accounting Standard No. 153, *Exchanges of Nonmonetary Assets, an Amendment of APB 29*, or SFAS 153, and (b) if nonmonetary transactions within the scope of APB 29 and SFAS 153 involve inventory, are there any circumstances under which the transactions should be recognized at fair value. The pronouncement is effective for new inventory arrangements entered into, or modifications or renewals of existing inventory arrangements occurring in interim or annual reporting periods beginning after March 15, 2006. This pronouncement did not have a material effect on our consolidated financial statements.

In June 2006, the FASB issued FASB Interpretation No. 48, or FIN 48, *Accounting for Uncertainty in Income Taxes*. FIN 48 provides interpretive guidance for recognition and measurement of tax positions taken or expected to be taken in a tax return. This interpretation is effective for fiscal years beginning after December 15, 2006. We are reviewing the impact of FIN 48, but do not expect the adoption of FIN 48 to have a material impact on our consolidated financial statements.

2. Computation of Net Income (Loss) Per Share

We have computed and presented net income (loss) per share under two methods, basic and diluted. Basic net income (loss) per share is computed by dividing net income (loss) by the weighted average number of common shares outstanding for the period. Diluted net income (loss) per share is computed by dividing net income (loss) by the sum of the weighted average number of common shares outstanding and potential common shares (when dilutive). A reconciliation of the numerator and the denominator of basic and diluted net income (loss) per share is as follows (in thousands, except per share amounts):

	Three Months Ended June 30, 2005	**2006**	**Six Months Ended June 30, 2005**	**2006**
Numerator -basic				
Net income (loss)	$ (19,587)	$ 1,455	$ (33,484)	$ 12,745
Denominator - basic				
Weighted average common stock outstanding	102,201	103,178	100,010	103,159
Basic net income (loss) per share	$ (0.19)	$ 0.01	$ (0.33)	$ 0.12
Denominator - diluted				
Weighted average common stock outstanding	102,201	103,178	100,010	103,159
Dilutive potential of common stock equivalents	-	1,351	-	1,475
Options	102,201	104,529	100,010	104,634
Diluted net income (loss) per share	$ (0.19)	$ 0.01	$ (0.33)	$ 0.12

Stock options to purchase 11,137,000 and 11,138,000 shares of common stock were outstanding for the three and six months ended June 30, 2005, with a weighted average exercise price of $7.71 for both periods. These stock options were not included in the computation of diluted net loss per share for the three and six months ended June 30, 2005 because we had a net loss for these periods. Stock options to purchase 8,450,580 and 8,492,481 shares with weighted average per share prices of $9.09 and $9.10, respectively, were outstanding and not included in the computation of diluted net income per share for the three and six months ended June 30, 2006, respectively, as they were anti-dilutive under the treasury stock method..

3. *Stock Compensation:*

Effective January 1, 2006, we adopted SFAS No. 123(R), *Share-Based Payments*. This statement requires us to expense the fair value of grants of various stock-based compensation programs over the vesting period of the awards. We elected to adopt the modified prospective application transition method which does not require the restatement of previously issued financial statements.

Employee Stock Purchase Plan:

Our 1995 Employee Stock Purchase Plan, or the Purchase Plan, as amended, has 6.0 million shares reserved for issuance. Through July 31, 2005, the Purchase Plan provided for eligible employees to purchase shares of common stock at a price equal to 85% of the fair market value of our common stock on the date of the option grant, or, if lower, 85% of the fair market value of our common stock six months after the option grant, by withholding up to 10 percent of their annual base earnings. Since July 31, 2005, the Purchase Plan provides for eligible employees to purchase shares of common stock at a price equal to 90% of the fair value of our common stock six months after the option date by withholding up to 10% of their annual base earnings. At June 30, 2005, 880 thousand shares were available for purchase under the Purchase Plan. Shares issued under the Purchase Plan for the six months ended June 30, 2005 and 2006 were 386 thousand 244 thousand, respectively.

Equity Incentive Plan:

Our 1995 Equity Incentive Plan, or the Equity Incentive Plan, as amended, has 31.8 million shares of common stock reserved for issuance upon the exercise of stock options to our employees, directors, consultants and affiliates. Under the Equity Incentive Plan, the Board of Directors has the authority to determine to whom options will be granted, the number of shares under option, the option term and the exercise price. The options generally are exercisable beginning one year from date of grant and generally thereafter over periods ranging from four to five years from the date of grant. The term of any options issued may not exceed ten years from the date of grant.

Directors Stock Option Plan:

Each of our non-employee directors receives stock option grants under our 1995 Non-Employee Directors Stock Option Plan, or the Directors Plan. In April 2005, the Board of Directors amended the Directors Plan. Pursuant to the Directors Plan, upon each non-employee director s initial election or appointment to the Board, such new non-employee director receives an initial stock option grant for 45,000 shares of common stock. Each initial stock option grant vests as to 25% of the shares subject to the grant on the anniversary of the grant date. Previously, each such initial stock option was fully vested and exercisable upon grant. In addition, each non-employee director will receive a fully vested annual stock option grant for 12,000 shares of common stock. Previously, each non-employee director received a fully vested annual stock option grant for 18,000 shares of common stock. The options expire ten years after the date of grant. As of June 30, 2006, the Directors Plan had 169 thousand shares available for issuance.

Compensation expense is recognized as follows: We amortize deferred stock-based compensation on the graded vesting method over the vesting periods of the stock options, generally four years. The graded vesting method provides for vesting of portions of the overall awards at interim dates and results in accelerated vesting as compared to the straight-line method.

The Employee Stock Purchase Plan, or the Purchase Plan, provides for eligible employees to purchase shares of common stock at a price equal to 90% of the fair value of our common stock on the last day of each six-months offering period. The compensation is the difference between the fair value and purchase price on the date of purchase.

The amount of recognized compensation expense is adjusted based upon an estimated forfeiture rate which is derived from historical data.

The following table shows total stock-based compensation expense included in the Condensed Consolidated Statement of Operations (in thousands):

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	Three Months Ended June 30, 2006	Six Months Ended June 30, 2006
Cost of goods sold	$ 153	$ 310
Research and development	792	1,772
Sales and marketing	237	497
General and administrative	583	1,223
Effect on pre-tax income	1,765	3,802
Tax effect of stock-based compensation expense		
Effect on net income	$ 1,765	$ 3,802
Effect on net income per share:		
Basic	$ 0.02	$ 0.04
Diluted	$ 0.02	$ 0.04

There were no compensation costs capitalized for either of the above periods for the three and six months ended June 30, 2006.

No similar expense was charged against income in the prior periods as we had elected to apply the provisions of APB No. 25, *Accounting for Stock Issued to Employees* to those periods as permitted by SFAS No. 123.

SFAS No. 123(R) also requires that the tax benefit from the exercise of options be reflected in the statement of cash flows as a cash inflow from financing activities. Prior to the adoption of SFAS No. 123(R), these tax benefits were reflected as a cash inflow from operations. Because we elected to adopt the modified prospective application transition method, the prior year statements of cash flows have not been restated. The tax benefit from the exercise of options was zero for the three and six months ended June 30, 2006.

Stock Option Plans

Pursuant to our 1995 Equity Incentive Plan and 1995 Non-Employee Director s Stock Option Plan, stock options are granted with an exercise price equal to the market price of our common stock at the date of grant. Substantially all of the options granted to employees are exercisable pursuant to a four-year vesting schedule with a maximum contractual term of ten years. The fair value of these options is estimated using the Black-Scholes option pricing model which incorporates the assumptions noted in the table below. The risk-free interest rate for periods within the expected life of the option is based on the U.S. Treasury bond rate in effect at the time of grant. .We do not pay dividends and do not expect to do so in the future. Expected volatilities are based on the historical performance of our common stock. The expected term of the options granted is 6.0 years calculated using the simplified method allowed under SAB 107.

The fair values of grants in the stated period were computed using the following assumptions for our stock option plans:

	Three Months Ended June 30, 2006	Six Months Ended June 30, 2006
Risk-free interest rate	4.8%	4.3%-4.8%
Dividend yield	0.0%	0.0%
Expected volatility	82.6%	77.0%-82.6%
Expected life	6.0 years	6.0 years

The following is a summary of all option activity for the three and six months ended June 30, 2006 (number of shares in thousands):

	Shares Available for Grant	Number of Shares Outstanding	Weighted Average Price	Weighted Average Remaining Term (in years)	Aggregate Intrinsic Value at June 30, 2006
Outstanding at December 31, 2005	3,162	11,687	$ 7.33		
Granted	(116)	116	$ 4.72		
Exercised		(82)	$ 2.57		
Forfeited	195	(195)	$ 5.89		
Expired	45	(45)	$ 14.00		
Outstanding at March 31, 2006	3,286	11,481	$ 7.30	6.13	$ 6,782
Granted	(270)	270	$ 3.95		
Exercised		(40)	$ 2.56		
Forfeited	349	(349)	$ 6.64		
Outstanding at June 30, 2006	3,365	11,362	$ 7.26	5.97	$ 5,545
Vested and Expected to Vest at June 30, 2006		11,162	$ 7.28	5.89	$ 5,523
Options Exercisable at June 30, 2006		7,471	$ 7.87	4.60	$ 5,119

A summary of our stock options outstanding at June 30, 2006 as follows (number of shares in thousands):

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number Outstanding	Weighted-Average Remaining Life	Weighted-Average Exercise Price	Number Outstanding	Weighted-Average Exercise Price
$ 0.44 - $ 1.46	1,118	1.71	$ 0.99	1,118	$ 0.99
$ 1.54 - $ 2.83	1,118	4.79	$ 2.73	875	$ 2.29
$ 3.07 - $ 4.35	1,139	7.15	$ 3.71	781	$ 3.68
$ 4.38 - $ 4.75	1,104	6.37	$ 4.54	798	$ 4.52
$ 4.82 - $ 5.05	1,211	8.27	$ 4.93	197	$ 4.96
$ 5.07 - $ 6.48	1,081	8.04	$ 6.05	231	$ 5.80
$ 6.66 - $ 8.40	1,136	7.74	$ 7.57	538	$ 7.71
$ 8.61 - $ 9.85	1,232	5.64	$ 9.25	926	$ 9.24
$ 9.92 - $ 17.79	1,178	5.67	$ 12.47	962	$ 12.42
$ 18.60 - $ 29.44	1,045	4.03	$ 21.29	1,045	$ 21.29
$ 0.44 - $ 29.44	11,362	5.97	$ 7.26	7,471	$ 7.87

	Three Months Ended June 30, 2006	Six Months Ended June 30, 2006
Weighted average grant date fair value of options granted	$ 2.80	$ 3.09
Total fair value of shares vested	1,802,000	3,543,000
Total intrinsic value of options exercised	$ 70,000	$ 275,000
Total cash received from employees as a result of employee stock option excercises and employee stock plan purchases	$ 103,000	$ 1,374,000

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We settle stock option exercises with newly issued shares of common stock. We do not have any equity instruments outstanding other than the options described above as of June 30, 2006.

Total unrecognized compensation expense from stock options was $9.8 million excluding estimated forfeitures, which is expected to be recognized over a weighted-average period of 1.42 years as follows, in thousands:

	Compensation Expense excluding Estimated Forfeitures
2006 (remaining six months)	$ 3,426
2007	4,121
2008	1,768
2009	483
2010	35
Total	$ 9,833

Pro Forma Information under SFAS 123 for the period prior to 2006

For the three and six months ended June 30, 2005, we applied the intrinsic value based method of accounting for stock options prescribed by APB No. 25. Accordingly, no compensation expense was recognized for these stock options since all options granted have an exercise price equal to the market value of the underlying stock on the grant date. If compensation expense had been recognized based on the estimate of the fair value of each option granted in accordance with the provisions of SFAS No. 123 *Accounting for Stock-Based Compensation* as amended by SFAS No. 148 *Accounting for Stock-Based Compensation Transition and Disclosure An Amendment of FASB Statement No. 123* , our net income would have been reduced to the following pro forma amounts as follows, in thousands:

	Three Months Ended June 30, 2005	Six Months Ended June 30, 2005
Net loss as reported	$ (19,587)	$ (33,484)
Add: Stock-based employee compensation expense in reported net income, net of related tax effects		
Deduct: total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(2,039)	(4,473)
Pro forma net loss	$ (21,626)	$ (37,957)
Basic loss per share		
As reported:	$ (0.19)	$ (0.33)
Pro forma:	$ (0.21)	$ (0.38)
Diluted net loss per share		
As reported:	$ (0.19)	$ (0.33)
Pro forma:	$ (0.21)	$ (0.38)

Pro forma compensation expense recognized under SFAS No. 123 does not consider potential forfeitures.

4. Investments

We consider cash and all highly liquid investments purchased with an original or remaining maturity of less than three months at the date of purchase to be cash equivalents. Substantially all of our cash and cash equivalents are in the custody of three major financial institutions.

Short and long-term investments, which are comprised of federal, state and municipal government obligations, foreign and public corporate debt securities and marketable equity securities, are classified as available-for-sale and carried at fair value, based on quoted market prices, with the unrealized gains or losses, net of tax, reported in shareholders equity as other comprehensive income. The cost of debt securities is adjusted for amortization of premiums and accretion of discounts to maturity, both of which are included in interest income. Realized gains and losses are recorded on the specific identification method. In the first quarter of 2006, we sold 4.0 million common

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shares of our investment in Powertech Technology, Incorporated, or PTI, for a pre-tax gain of approximately $12.2 million. We owned approximately 5.5 million shares of PTI at June 30, 2006.

King Yuan Electronics Company Limited, or KYE, Insyde Software Corporation, or Insyde, PTI, and Professional Computer Technology Limited, or PCT, are Taiwanese companies that are listed on the Taiwan Stock Exchange. Equity investments in these companies have been included in Long-term available-for-sale investments. The investments that are not available for resale due to local securities regulations within one year at the balance sheet date are recorded at the investment cost. The investments that are available for resale within one year at the balance sheet date are recorded at fair market value, with unrealized gains and losses, net of tax, reported in Shareholders Equity as Other Comprehensive Income. If a decline in value is judged to be other than temporary, it is reported as an Impairment of equity investments. Cash dividends and other distributions of earnings from the investees, if any, are included in other income when declared.

In the first quarter of 2006, we determined our investment in Nanotech Corporation, or Nanotech, a privately held Cayman Island company, had become impaired as Nanotech defaulted on loan payments to certain of its business partners and is now in the process of discontinuing operations. Consequently, our remaining investment of $3.3 million along with a loan of $225 thousand were written down to a net realizable value of zero.

The fair values of available-for-sale investments as of June 30, 2006 were as follows (in thousands):

	Amortized Cost	**Unrealized Gain**	**Unrealized Loss**	**Fair Value**
Corporate bonds and notes	$ 15,621	$ 13	**$**	$ 15,634
Government bonds and notes	52,216		(19)	52,197
Foreign listed equity securities	5,999	16,501		22,500
Total bonds, notes and equity securities	$ 73,836	$ 16,514	$ (19)	$ 90,331
Less amounts classified as cash equivalents				(39,460)
Total short and long-term available-for-sale investments				$ 50,871

Contractual maturity dates of our available-for-sale investments for debt securities are all in 2006. All of these securities are classified as current as they are expected to be realized in cash or sold or consumed during the normal operating cycle of our business.

The unrealized gains and losses as of June 30, 2006 are recorded in accumulated other comprehensive income, net of tax.

The fair values of available-for-sale investments as of December 31, 2005 were as follows (in thousands):

	Amortized Cost	**Unrealized Gain**	**Unrealized Loss**	**Fair Value**
Corporate bonds and notes	$ 67	$	$	$ 67
Government bonds and notes	5,632		(1)	5,631
Foreign listed equity securities	7,283	31,774		39,057
Total bonds, notes and equity securities	$ 12,982	$ 31,774	$ (1)	$ 44,755
Less amounts classified as cash equivalents				(4,690)
Total short and long-term available-for-sale investments				$ 40,065

The unrealized gains and losses as of December 31, 2005 are recorded in accumulated other comprehensive income, net of tax.

Market values were determined for each individual security in our investment portfolio. The declines in value of the government bonds and notes primarily relate to changes in the interest rates and are considered temporary in nature. With respect to our foreign listed equity securities, our policy is to review our equity holdings on a regular basis to evaluate whether or not such securities have experienced an other than temporary decline in fair value. Our policy

includes, but is not limited to, reviewing each company s cash position, earnings and revenue outlook, stock price performance over the past six months, liquidity, management and ownership. If we believe that an other-than-temporary decline in value exists, it is our policy to write down these investments to the market value and record the related write-down in our consolidated statement of operations.

Investments in privately held enterprises and certain restricted stocks are accounted for using either the cost or equity method of accounting. As of June 30, 2006, the carrying value of these investments was $95.8 million, which includes an investment of $83.2 million in Grace Semiconductor Manufacturing Corporation, or GSMC, which represents a 10% interest. As of December 31, 2005, the carrying value of these investments was $96.1 million.

5. Selected Balance Sheet Detail

Details of selected balance sheet accounts are as follows (in thousands):

Inventories comprise:

	December 31, 2005	June 30, 2006
Raw materials	$ 65,404	$ 59,754
Work in process	6,491	5,278
Finished goods	29,450	23,840
Finished goods inventories held at logistics center	6,998	5,561
	$ 108,343	$ 94,433

Inventories are stated at the lower of cost, determined on a first-in, first-out basis, or market value. We typically plan our production and inventory levels based on internal forecasts of customer demand, which are highly unpredictable and can fluctuate substantially. The value of our inventory is dependent on our estimate of future average selling prices, and, if our projected average selling prices are over estimated, we may be required to adjust our inventory value. If we over estimate future market demand, we may end up with excess inventory levels that cannot be sold within a normal operating cycle and we may be required to record a provision for excess inventory. Our inventories include high technology parts and components that are specialized in nature or subject to rapid technological obsolescence. Some of our customers have requested that we ship them product that has a finished goods date of manufacture less than one year old. In the event that this becomes a common requirement, it may be necessary for us to provide for an additional allowance for our on-hand finished goods inventory with a date of manufacture of greater than one year old, which could result in a material adjustment and could harm our financial results. We review on-hand inventory including inventory held at the logistic center for potential excess, obsolescence and lower of cost or market exposure and record provisions accordingly. Due to the large number of units in our inventory, even a small change in average selling prices could result in a significant adjustment and have a material impact on our financial position and results of operations.

Our allowance for excess and obsolete inventories includes an allowance for finished goods inventory with a date of manufacture of greater than two years old and for certain products with a date of manufacture of greater than one year old. In addition, our allowance includes an allowance for die, work-in-process and finished goods that exceed our estimated forecast for the next twelve to twenty four months. For the obsolete inventory analysis, we review inventory items in detail and consider date code, customer base requirements, known product defects, planned or recent product revisions, end of life plans and diminished market demand. For excess inventory analysis, we review inventory items in detail and consider our customer base requirements and market demand. While we have programs to minimize inventories on hand and we consider technological obsolescence when estimating allowances for potentially excess and obsolete inventories and those required to reduce recorded amounts to market values, it is reasonably possible that such estimates could change in the near term. Such changes in estimates could have a material impact on our financial position and results of operations.

Accrued expenses and other liabilities comprise (in thousands):

	December 31, 2005	June 30, 2006
Accrued compensation and related items	$ 5,934	$ 6,880
Accrued adverse purchase commitments	1,752	1,306
Accrued commission	2,762	2,671
Accrued income tax payable	1,319	4,076
Accrued warranty	803	910
Other accrued liabilities	4,748	5,709
	$ 17,318	$ 21,552

Changes in the warranty reserves during the three months ended June 30, 2005 and 2006 were as follows (in thousands):

	Six Months Ended June 30, 2005	2006
Beginning balance	$ 3,826	$ 803
Provisions for warranty	1,418	1,736
Change in estimate of prior period accrual	(500)	
Consumption of reserves	(2,662)	(1,629)
Ending balance	$ 2,082	$ 910

Our products are generally subject to warranty and we provide for the estimated future costs of repair, replacement or customer accommodation upon shipment of the product in our condensed consolidated statements of operations. Our warranty accrual is estimated based on historical claims compared to historical revenues. For new products, we use our historical percentage for the appropriate class of product. The higher warranty reserve as of June 30, 2005 compared to June 30, 2006 related mainly to the rescreening work related to two specific customers. The work was completed during 2005 so there is no comparable reserve as of June 30, 2006.

6. Commitments

Our technology license agreements generally include an indemnification clause that indemnifies the licensee against liability and damages (including legal defense costs) arising from any claims of patent, copyright, trademark or trade secret infringement by our proprietary technology. The terms of these guarantees approximate the terms of the technology license agreements, which typically range from five to ten years. Our current license agreements expire from 2006 through 2014. The maximum possible amount of future payments we could be required to make, if such indemnifications were required on all of these agreements, is $41.7 million. We have not recorded any liabilities as of June 30, 2006 related to these indemnities as no such claims have been made or asserted.

During our normal course of business, we have made certain indemnities, commitments and guarantees under which we may be required to make payments in relation to certain transactions. These include indemnities to various lessors in connection with facility leases for certain claims arising from such facility or lease and indemnities to our directors and officers to the maximum extent permitted under the laws of California. In addition, we have contractual commitments to some customers, which could require us to incur costs to repair an epidemic defect with respect to our products outside the normal warranty period if such defect were to occur. The duration of these indemnities, commitments and guarantees varies. The majority of these indemnities, commitments and guarantees do not provide for any limitation of the maximum potential future payments that we could be obligated to make. We have not recorded any liability for these indemnities, commitments and guarantees in the accompanying condensed consolidated balance sheets. We do, however, accrue for losses for any known contingent liability, including those that may arise from indemnification provisions, when future payment is probable and the amount is reasonably estimatable.

7. Contingencies

In January and February 2005, multiple putative shareholder class action complaints were filed against SST and certain directors and officers, in the United States District Court for the Northern District of California, following our announcement of anticipated financial results for the fourth quarter of 2004. On March 24, 2005, the putative

class actions were consolidated under the caption *In re Silicon Storage Technology, Inc., Securities Litigation,* Case No. C 05 00295 PJH (N.D. Cal.). On May 3, 2005, the Honorable Phyllis J. Hamilton appointed the Louisiana Funds Group, consisting of the Louisiana School Employees Retirement System and the Louisiana District Attorneys Retirement System, to serve as lead plaintiff and the law firms of Pomeranz Haudek Block Grossman & Gross LLP and Berman DeValerio Pease Tabacco Burt & Pucillo to serve as lead counsel and liason counsel, respectively, for the class. The lead plaintiff filed a Consolidated Amended Class Action Complaint on July 15, 2005. The complaint seeks unspecified damages on alleged violations of federal securities laws during the period from April 21, 2004 to December 20, 2004. We moved to dismiss the complaint on September 16, 2005. Plaintiff served an opposition to the motion to dismiss on November 4, 2005. Our reply in further support of the motion to dismiss was filed on December 19, 2005. On January 18, 2006, the Court heard arguments on the motion to dismiss. On March 10, 2006, the Court granted our motion to dismiss the consolidated amended complaint, with leave to file an amended complaint. Plaintiffs filed a second amended complaint on May 1, 2006. We responded with a motion to dismiss on June 19, 2006. We intend to take all appropriate action in response to these lawsuits. The impact related to the outcome of these matters is undeterminable at this time.

In January and February 2005, following the filing of the putative class actions, multiple shareholder derivative complaints were filed in California Superior Court for the County of Santa Clara, purportedly on behalf of SST against certain of our directors and officers. The factual allegations of these complaints are substantially identical to those contained in the putative shareholder class actions filed in federal court. The derivative complaints assert claims for, among other things, breach of fiduciary duty and violations of the California Corporations Code. These derivative actions have been consolidated under the caption *In Re Silicon Storage Technology, Inc. Derivative Litigation*, Lead Case No. 1:05CV034387 (Cal. Super. Ct., Santa Clara Co.). On April 28, 2005, the derivative action was stayed by court order. We intend to take all appropriate action in response to these lawsuits. The impact related to the outcome of these matters is undeterminable at this time.

On July 13, 2006, a shareholder derivative complaint was filed in the United States District Court for the Northern District of California by Mike Brien under the caption *Brien v. Yeh, et al*., Case No. C06-04310 JF (N.D. Cal.). On July 18, 2006, a shareholder derivative complaint was filed in the United States District Court for the Northern District of California by Behrad Bazargani under the caption *Bazargani v. Yeh, et al*., Case No. C06-04388 HRL (N.D. Cal.). Both complaints were brought purportedly on behalf of us against certain of our current and former officers and directors and allege among other things, that the named officers and directors: (a) breached their fiduciary duties as they colluded with each other to backdate stock options, (b) violated Rule 10b-5 of the Securities Exchange Act of 1934 through their alleged actions, and (c) were unjustly enriched by their receipt and retention of such stock options. We intend to take all appropriate action in responding to the complaints.

From time to time, we are also involved in other legal actions arising in the ordinary course of business. We have accrued certain costs associated with defending these matters. There can be no assurance that the shareholder class action complaints, the shareholder derivative complaints or other third party assertions will be resolved without costly litigation, in a manner that is not adverse to our financial position, results of operations or cash flows or without requiring royalty payments in the future which may adversely impact gross margins. No estimate can be made of the possible loss or possible range of loss associated with the resolution of these contingencies. As a result, no losses have been accrued in our financial statements as of June 30, 2006.

8. Line of Credit

On August 11, 2005, we entered into a 1-year loan and security agreement with Cathay Bank for a $35.0 million revolving line of credit, all of which was available to us as of June 30, 2006. The line of credit will be used for working capital but there are no restrictions in the agreement as to how the funds may be used. The interest rate for the line of credit is 1% below the prime rate reported from time to time by the Wall Street Journal, Western Edition (8.25% at June 30, 2006). The line of credit is collateralized by substantially all of the assets of SST other than intellectual property. The agreement contains certain financial covenants, including the levels of qualifying accounts receivable and inventories, which could limit the availability of funds under the agreement. There were no borrowings under this line as of June 30, 2006.

On July 16, 2004, we entered into a 2-year loan agreement with Cathay Bank, a U.S. bank, for a $3.0 million revolving line of credit. The interest rate for the line of credit is 3.475% per annum. The line of credit is collateralized by a $3.0 million certificate of deposit which is included in non-current other assets. The loan agreement was extended in July 2006 and now matures in September 2006. It carries an interest rate of 2.6% per annum. As of December 31, 2005, and June 30, 2006, we had borrowed $3.0 million under our line of credit.

9. Goodwill and Intangible Assets:

Our acquisitions in prior years included the acquisition of $16.5 million of finite-lived intangible assets. Certain of our acquisitions also included an aggregate of $29.6 million of goodwill. The goodwill is not being amortized but is tested for impairment annually, as well as when an event or circumstance occurs indicating a possible impairment in value. Of our $1.5 million of intellectual property assets, $1.2 million was acquired prior to fiscal 2006 and included in property, plant and equipment.

As of June 30, 2006, our intangible assets consisted of the following (in thousands):

	Cost	Accumulated Amortization	Net
Existing technology	$ 11,791	$ 4,122	$ 7,669
Intellectual property	1,517		1,517
Trade name	1,198	433	765
Customer relationships	1,857	777	1,080
Backlog	811	811	
Non-Compete Agreements	810	296	514
	$ 17,984	$ 6,439	$ 11,545

As of December 31, 2005, our intangible assets consisted of the following (in thousands):

	Cost	Accumulated Amortization	Net
Existing technology	$ 11,791	2,830	$ 8,961
Trade name	1,198	313	885
Customer relationships	1,857	528	1,329
Backlog	811	806	5
Non-Compete Agreements	810	174	636
	$ 16,467	$ 4,651	$ 11,816

All intangible assets are being amortized on a straight-line method over their estimated useful lives. Existing technologies have been assigned useful lives of between four and five years, with a weighted average life of approximately 4.6 years. Non-compete agreements have been assigned useful lives between two and four years, with a weighted average of 3.6 years. Intellectual property has been assigned an estimated life of five years and will begin amortization as it is put into service. Trade names, customer relationships and backlogs have been assigned useful lives of five years, three years and one year, respectively. Amortization expense for intangible assets for the six months ended June 30, 2006 was $1.8 million.

Estimated future intangible asset amortization expense for the next five years is as follows (in thousands):

Fiscal Year	Amortization of Intangible Assets
2006 remaining six months	$ 1,782
2007	3,675
2008	3,376
2009	1,938
2010 and after	774
	$ 11,545

There was no change in the carrying amount of goodwill for the six months ended June 30, 2006 from December 31, 2005.

10. Segment Reporting

A key objective of ours is to diversify our product offerings from primarily flash to a multi-product line company and to be a leading worldwide supplier of low to medium density NOR flash memory devices, a leading supplier of other semiconductor products in the consumer electronics market and a leading licensor of embedded flash technology. As a result, the operating results that the company s chief operating decision maker reviews to make decisions about resource allocations and to assess performance have changed. Effective January 1, 2006, we have re-evaluated our operating segments to bring them in line with our key objectives and focus. The new segments include Memory Products, Non-Memory Products and Technology Licensing.

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

Our Non-Memory Products segment includes other semiconductor products including flash microcontrollers, smart card integrated circuit, or ICs, and modules, radio frequency, or RF, ICs and modules and NAND controller products and modules.

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

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

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

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

	Three Months Ended June 30, 2005		Three Months Ended June 30, 2006	
	Revenues	Gross Profit	Revenues	Gross Profit
Memory	$ 74,942	$ 3,122	$ 82,970	$ 14,036
Non-Memory	9,940	(277)	15,968	4,547
Technology Licensing	8,417	8,417	8,791	8,791
	$ 93,299	$ 11,262	$ 107,729	$ 27,374

	Six Months Ended June 30, 2005		Six Months Ended June 30, 2006	
	Revenues	Gross Profit	Revenues	Gross Profit
Memory	$ 142,934	$ 4,073	$ 163,008	$ 31,972
Non-Memory	21,218	4,320	36,233	10,296
Technology Licensing	15,462	15,462	19,019	19,019
	$ 179,614	$ 23,855	$ 218,260	$ 61,287

11. Comprehensive Income (Loss)

The components of comprehensive income (loss), net of tax, are as follows (in thousands):

	For the Three Months Ended		For the Six Months Ended	
	June 30, 2005	June 30, 2006	June 30, 2005	June 30, 2006
Net income (loss)	$ (19,587)	$ 1,455	$ (33,484)	$ 12,745
Other comprehensive income:				
Change in unrealized gains on investments, net of tax	5,889	(2,653)	9,790	(15,279)
Change in cumulative translation adjustment	(104)	5	(35)	16
Total comprehensive income	$ (13,802)	$ (1,193)	$ (23,729)	$ (2,518)

The components of accumulated other comprehensive income are as follows (in thousands):

	Balances as of December 31, 2005	June 30, 2006
Components of accumulated other comprehensive income:		
Net unrealized gains on investments, net of tax	$ 31,774	$ 16,495
Cumulative translation adjustment	6	22
	$ 31,780	$ 16,517

12. Related Party Transactions and Balances

The following table is a summary of our related party revenues and purchases for the three and six months months ended June 30, 2005 and 2006, and our related party accounts receivable and accounts payable and accruals as of December 31, 2005 and June 30, 2006 (in thousands):

	Three Months Ended June 30, 2005 Revenues	Purchases	Three Months Ended June 30, 2006 Revenues	Purchases
Silicon Technology Co., Ltd	$ 1,139	$	$ 260	$
Apacer Technology, Inc. & related entities	518		714	
Silicon Professional Technology Ltd	46,353		57,189	
Grace Semiconductor Manufacturing Corp	29	11,431		14,319
King Yuan Electronics Company, Limited		7,654		7,029
Powertech Technology, Incorporated		3,125		3,113
	$ 48,039	$ 22,210	$ 58,163	$ 24,461

	Six Months Ended June 30, 2005 Revenues	Purchases	Six Months Ended June 30, 2006 Revenues	Purchases
Silicon Technology Co., Ltd	$ 1,838	$	$ 486	$
Apacer Technology, Inc. & related entities	842		1,680	
Silicon Professional Technology Ltd	86,979		118,268	
Grace Semiconductor Manufacturing Corp	131	34,772	1,378	24,142
King Yuan Electronics Company, Limited		16,822		15,033
Powertech Technology, Incorporated		6,827		6,904
	$ 89,790	$ 58,421	$ 121,812	$ 46,079

	December 31, 2005 Trade Accounts Receivable	Accounts Payable and Accruals	June 30, 2006 Trade Accounts Receivable	Accounts Payable and Accruals
Silicon Technology Co., Ltd	$ 370	$	$ 127	$
Apacer Technology, Inc. & related entities	237		319	
Professional Computer Technology Limited		123		127
Silicon Professional Technology Ltd	53,785	846	37,455	869
Grace Semiconductor Manufacturing Corp	1,466	4,949	68	9,391
King Yuan Electronics Company, Limited		10,004		7,162
Powertech Technology, Incorporated		5,945		4,242
	$ 55,858	$ 21,867	$ 37,969	$ 21,791

Professional Computer Technology Limited, or PCT, earns commissions for point-of-sales transactions to customers. PCT s commissions are paid at the same rate as all of our other stocking representatives in Asia. In addition, we pay Silicon Professional Technology Ltd., or SPT, a wholly-owned subsidiary of PCT, a fee for providing logistics center functions. This fee is based on a percentage of revenue for each product shipped through SPT to our end customers. The fee paid to SPT covers the costs of warehousing and insuring inventory and processing accounts receivable, the personnel costs required to maintain logistics and information technology functions and the costs to perform demand forecasting, billing and collection of accounts receivable.

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13. Income Taxes

We maintained a full valuation allowance on our net deferred tax assets as of June 30, 2006. The valuation allowance was determined in accordance with the provisions of Statement of Financial Accounting Standards No. 109, or SFAS No. 109, *Accounting for Income Taxes*, which requires an assessment of both positive and negative evidence when determining whether it is more likely than not that deferred tax assets are recoverable; such assessment is required on a jurisdiction by jurisdiction basis. Cumulative losses incurred in the U.S. in recent years represented sufficient negative evidence under SFAS No. 109 such that a full valuation allowance was recorded against U.S. deferred tax assets. We intend to maintain a full valuation allowance in the U.S. deferred tax assets until sufficient positive evidence exists to support reversal of the valuation allowance. Our tax provision for the three and six months ended June 30, 2006 was $1.0 million and $3.3 million, respectively, which consists primarily of foreign withholding taxes and tentative U.S. minimum tax.

Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations.

The following discussion may be understood more fully by reference to the consolidated financial statements, notes to the consolidated financial statements and management s discussion and analysis of financial condition and results of operations contained in our Annual Report on Form 10-K for the year ended December 31, 2005, as filed with the Securities and Exchange Commission.

The following discussion contains forward-looking statements, which involve risk and uncertainties. All forward-looking statements included in this document are based on information available to us on the date hereof, and we assume no obligation to update any such forward-looking statements. Our actual results could differ materially from those anticipated in these forward-looking statements as a result of certain factors which are difficult to forecast and can materially affect our quarterly or annual operating results. Fluctuations in revenues and operating results may cause volatility in our stock price. Please also see Part II, Item 1A. Risk Factors.

Overview

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

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

We also produce and sell other semiconductor products including flash microcontrollers, smartcard ICs and modules, radio frequency, or RF, ICs and modules and memory controllers.

One of our key initiatives is the active development of our non-memory business. Our objective is to transform SST from a pure-play in flash to a multi-product line company. We continue to execute on our plan to derive, by mid-2008, 30% of our revenue from non-memory products, which includes embedded controllers, NAND controller based products, smart card ICs and radio frequency ICs and modules. We believe non-memory products represent an area in which we have significant competitive advantages and also an area that can yield profitable revenue with higher and more stable gross margins than our memory products in the long run.

As a result of the transition in our objectives, the operating results that our chief executive officer reviews to make decisions about resource allocations and to assess our performance have changed. Effective January 1, 2006, we have re-evaluated our operating segments to bring them in line with our key objectives and focus. The new segments include Memory Products, Non-Memory Products and Technology Licensing. For other information related to our segments, see Note 10 Segment Reporting to our Notes to the Consolidated Financial Statements.

The second quarter of 2006 ended a relatively weak first half of 2006, although we expect to see strengthening demand in the second half of the year. Sales in the Internet computing and digital consumer applications during the second quarter were seasonally low. Revenue from the networking and wireless communications applications, however, was strong. Revenues from wireless communications surpassed that of Internet computing and became our second largest application in the second quarter

Looking at our application categories, unit shipments to the Internet computing application were negatively affected. Shipments decreased 2.5% in the second quarter due to weak demand for desktop PCs, notebook PC and graphic card applications. However, we had record unit shipments to the server and LCD monitor applications. Unit shipments to the digital consumer category decreased 11.1% in the second quarter due to softness in the DVD player, DVD ROM drive, MP3 player, and digital TV applications. Shipments to the digital camera, DVD RW drive, set-top box and video game applications remained strong. We expect shipments to the digital consumer market to improve during the third quarter as we approach the holiday season. Units shipped to the wireless communications market increased by 11.5% in the second quarter due to record unit shipments to the GPS module and cell phone applications, as well as the renewed strength in Bluetooth and cordless phone applications. Further, due to higher average selling price from ComboMemory products for the cell phone market, revenue from the wireless communications market improved more than 25% and became our second highest revenue source during the second quarter. We expect the GPS and low cost cell phone applications to continue to be a growth driver for the wireless communications market. The demand in the networking segment rebounded strongly and increased 62.2% in units shipped and 39.6% in revenue sequentially from the first quarter due to the strong shipments to the DSL modem, Wireless LAN and networking equipment applications. Overall, unit shipments in the second quarter of 2006 increased by 0.9% compared with the prior quarter.

In the area of memory technologies, we are continuing to reduce manufacturing costs through the transition to smaller process technologies that generally carry a lower cost per die. Substantially all of our new wafer starts are now in 0.25 micron and 0.18 micron geometries. We are in the process of developing 0.13 micron and 0.12 micron process technologies.

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

Our product sales are made primarily using short-term cancelable purchase orders. The quantities actually purchased by the customer, as well as shipment schedules, are frequently revised to reflect changes in the customer s needs and in our supply of product. Accordingly, our backlog of open purchase orders at any given time is not a meaningful indicator of future sales. Changes in the amount of our backlog do not necessarily reflect a corresponding change in the level of actual or potential sales.

We derived 86.0%, 87.6% and 87.4% of our net product revenues during 2004, 2005 and the six months ended June 30, 2006, respectively, from product shipments to Asia. Additionally, substantially all of our wafer suppliers and packaging and testing subcontractors are located in Asia.

Our top ten end customers, excluding stocking representatives and distributors, accounted for 29.1%, 27.2% and 21.7% of our net product revenues in 2004, 2005 and the six months ended June 30, 2006, respectively.

No single end customer, which we define as original equipment manufacturers, or OEMs, original design manufacturers, or ODMs, contract electronic manufacturers, or CEMs, or end users, represented 10.0% or more of our net product revenues during 2004, 2005 or the six months ended June 30, 2006.

We out-source our end customer service logistics in Asia to Silicon Professional Technology Ltd., or SPT, which supports our customers in Taiwan, China and other Southeast Asia countries. SPT provides forecasting, planning, warehousing, delivery, billing, collection and other logistic functions for us in these regions. SPT is a wholly-owned subsidiary of Professional Computer Technology Limited, or PCT, one of our stocking representatives in Taiwan. Please see a description of our relationship with PCT under Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations - Related Party Transactions in our Annual Report on Form 10-K for the year ended December 31, 2005. Products shipped to SPT are accounted for as our inventory held at our logistics center, and revenue is recognized when the products have been delivered and are considered as a sale to our end customers by SPT. For 2004 and 2005 and the six months ended June 30, 2006, SPT serviced end customer sales accounting for 52.9%, 58.5% and 59.4%, respectively, of our net product revenues recognized. As of December 31, 2005 and June 30, 2006, SPT represented 69.6% and 63.1% of our net accounts receivable, respectively.

We ship products to, and have accounts receivable from, OEMs, ODMs, CEMs, stocking representatives, distributors and our logistics center. Our stocking representatives, distributors and logistics center reship our products to our end customers, including OEMs, ODMs, CEMs and end users. Shipments, by us or our logistics center, to our top three stocking representatives for reshipment accounted for 34.0%, 40.3% and 46.8% of our product shipments in 2004, 2005 and the six months ended June 30, 2006, respectively. In addition, the top three stocking representatives solicited sales, for which they received a commission, for 25.1%, 18.3% and 10.2% of our shipments to end users in 2004, 2005 and the six months ended June 30, 2006, respectively.

Critical Accounting Estimates

Effective January 1, 2006, we adopted the fair value recognition provisions of Financial Accounting Standards Board, or FASB, Statement of Financial Accounting Standards, or SFAS, No. 123(R), *Share-Based Payments*, using the modified prospective application method. Under this transition method, compensation cost recognized in the quarter ended June 30, 2006 includes the applicable amounts of: (a) compensation cost of all stock-based payments granted prior to, but not yet vested as of, January 1, 2006 (based on the grant-date fair value estimated in accordance with the original provisions of SFAS No. 123 and previously presented in the pro forma footnote disclosures), and (b) compensation cost for all stock-based payments granted subsequent to January 1, 2006 (based on the grant-date fair value estimated in accordance with the new provisions of SFAS No. 123(R)). Results for prior periods have not been restated to reflect our adoption of SFAS No. 123(R).

For other information related to our revenue recognition and other critical accounting estimates, please refer to the Critical Accounting Estimates section of Management s Discussion and Analysis of Financial Condition and Results of Operations contained in our Annual Report on Form 10-K for the year ended December 31, 2005.

Results of Operations: Three and Six Months Ended June 30, 2006

Net Revenues (in thousands)

	Three Months Ended June 30, 2005	March 31, 2006	June 30, 2006	2Q06-Over-2Q05 Change		2Q06-Over-1Q06 Change	
Memory Revenue	$ 74,942	$ 80,038	$ 82,970	$ 8,028	10.7 %	$ 2,932	3.7 %
Non-Memory Revenue	$ 9,940	$ 20,265	$ 15,968	$ 6,028	60.6 %	$ (4,297)	(21.2)%
Product revenues	$ 84,882	$ 100,303	$ 98,938	$ 14,056	16.6 %	$ (1,365)	(1.4)%
Technology licensing	$ 8,417	$ 10,228	$ 8,791	$ 374	4.4 %	$ (1,437)	(14.0)%
Total net revenues	$ 93,299	$ 110,531	$ 107,729	$ 14,430	15.5 %	$ (2,802)	(2.5)%

	Six Months Ended June 30, 2005	June 30, 2006	2Q06-Over-2Q05 Change	
Memory Revenue	$ 142,934	$ 163,008	$ 20,074	14.0 %
Non-Memory Revenue	$ 21,218	$ 36,233	$ 15,015	70.8 %
Product revenues	$ 164,152	$ 199,241	$ 35,089	21.4 %
Technology licensing	$ 15,462	$ 19,019	$ 3,557	23.0 %
Total net revenues	$ 179,614	$ 218,260	$ 38,646	21.5 %

Net revenues decreased 2.5% in the second quarter of 2006 from the first quarter of 2006 primarily due to a 21.2% decrease in non-memory product revenue and lower technology license revenue due mainly to the timing of up-front license fees. Average selling prices of our products for the second quarter of 2006 decreased 2.8% from the first quarter of 2006 due to product mix as well as pricing pressures on serial flash and higher density products. Net revenues for the second quarter of 2006 increased 15.5% compared to the second quarter of 2005 due to a 13.7% increase in unit shipments, a 3.5% increase in blended average selling prices and increased royalty revenue. For the six months ended June 30, 2006, net revenues increased 21.5% as compared to the same period in the prior year due to a 19.3% increase in total units shipped and higher technology license revenue.

The following discussions are based on our reportable segments described in Note 10 of the Notes to the Unaudited Condensed Consolidated Financial Statements.

Memory Products

Memory revenue increased 3.7% in the second quarter of 2006 from the first quarter of 2006 primarily due to a 1.5% increase in unit shipments. Weaker demand for several consumer electronic and computer applications led to the modest results. Memory revenue increased in the second quarter of 2006 compared to the second quarter of 2005 primarily due to an 8.2% increase in unit shipments and a 2.5% increase in average selling prices. The increases came largely from increases in unit shipments of serial flash devices, multi-purpose flash plus and ComboMemory products. For the six months ended June 30, 2006 compared to the same period in 2005, memory revenue increased due a 14.7% increase in unit shipments led primarily by increased activity of serial flash devices and ComboMemory products.

Non-Memory Products

Non-memory revenue declined in the second quarter of 2006 from the first quarter of 2006 primarily due to a 1.5% decrease in unit shipments and an 11.5% decrease in our average selling price. Product mix and pricing pressures on some of our smartcard ICs led to the declines. Non-memory revenue increased in the second quarter of 2006 compared to the second quarter of 2005 primarily due to a 45.5% increase in unit shipments and a 17.0% increase in average selling prices due to product mix. The increases came largely from increases in unit shipments of NAND controllers and communications products. For the six months ended June 30, 2006 compared to the same period in 2005, non-memory revenue increased due to a 43.1% increase in unit shipments driven by NAND controllers and communications products.

Technology Licensing Revenue

Technology license revenue includes a combination of up-front fees and royalties. Technology licensing revenue for the second quarter of 2006 declined from the first quarter of 2006 as a result of lower upfront fees as well as some fluctuation in royalties. Technology licensing revenue for the second quarter of 2006 increased slightly compared to the second quarter of 2005 due to timing of fees. For the six months ended June 30, 2006 technology license revenues, compared to the same period in 2005, increased 22.8% primarily due to license fees on new and existing licenses. We anticipate revenues from technology licensing may fluctuate significantly in the future.

Gross Profit (in thousands)

	Three Months Ended							
	June 30, 2005		March 31, 2006		June 30, 2006		2Q06-Over-2Q05 Change		2Q06-Over-1Q06 Change	
Memory gross profit	$ 3,122		$ 17,936		$ 14,036		$ 10,914	349.6 %	$ (3,900)	(21.7)%
Memory gross margin	4.2	%	22.4	%	16.9	%				
Non-Memory gross profit	$ (277)		$ 5,749		$ 4,547		$ 4,824	(1741.5)%	$ (1,202)	(20.9)%
Non-Memory gross margin	-2.8	%	28.4	%	28.5	%				
Product gross profit	$ 2,845		$ 23,685		$ 18,583		$ 15,738	553.2 %	$ (5,102)	(21.5)%
Product gross margin										

Gross Profit (in thousands) 37