SIMPLETECH INC
Form 10-Q
May 15, 2006
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x **QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended March 31, 2006

or

¨ **TRANSITION REPORT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from ________ to ________

Commission File Number 000-31623

SIMPLETECH, INC.

(Exact name of Registrant as specified in its charter)

CALIFORNIA	**33-0399154**
(State or other jurisdiction	**(I.R.S. Employer**
of incorporation or organization)	**Identification No.)**
3001 Daimler Street	
Santa Ana, CA	**92705-5812**
(Address of principal executive offices)	**(Zip Code)**

(949) 476-1180

(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 ¨

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 x

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

The number of shares outstanding of the registrant s common stock, par value $0.001, as of April 30, 2006 was 45,578,532.

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SIMPLETECH, INC.

INDEX TO FORM 10-Q FOR THE

QUARTERLY PERIOD ENDED MARCH 31, 2006

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

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PART I FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

SIMPLETECH, INC.

CONSOLIDATED BALANCE SHEETS

(in thousands, except share and per share amounts)

(unaudited)

	March 31, 2006	December 31, 2005
ASSETS:		
Current Assets:		
Cash and cash equivalents	$ 62,078	$ 60,006
Accounts receivable, net of allowances of $1,770 at March 31, 2006 and $878 at December 31, 2005	42,371	38,630
Inventory, net	33,596	37,108
Deferred income taxes	1,595	1,410
Other current assets	2,957	3,825
Total current assets	142,597	140,979
Furniture, fixtures and equipment, net	9,402	8,231
Intangible assets	975	1,036
Goodwill	1,682	733
Other long-term assets	1,803	1,647
Deferred income taxes	2,568	2,515
Total assets	$ 159,027	$ 155,141
LIABILITIES AND SHAREHOLDERS EQUITY:		
Current Liabilities:		
Accounts payable	$ 22,471	$ 20,564
Accrued and other liabilities (Note 5)	7,290	7,195
Total liabilities	29,761	27,759
Commitments and contingencies (Note 6)		
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, 45,368,682 shares issued and outstanding as of March 31, 2006 and 45,043,568 shares issued and outstanding as of December 31, 2005	45	45
Additional paid-in capital	112,419	111,576
Retained earnings	16,802	15,761
Total shareholders equity	129,266	127,382
Total liabilities and shareholders equity	$ 159,027	$ 155,141

See accompanying notes to unaudited consolidated financial statements.

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SIMPLETECH, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share amounts)

(unaudited)

	Three Months Ended March 31, 2006	Three Months Ended March 31, 2005
Net revenues	$ 65,491	$ 61,247
Cost of revenues	52,819	50,264
Gross profit	12,672	10,983
Sales and marketing	5,886	5,380
General and administrative	3,643	3,078
Research and development	2,048	1,287
Total operating expenses	11,577	9,745
Operating income	1,095	1,238
Interest income	475	435
Income before provision for income taxes	1,570	1,673
Provision for income taxes	529	637
Net income	$ 1,041	$ 1,036
Net income per share:		
Basic	$ 0.02	$ 0.02
Diluted	$ 0.02	$ 0.02
Shares used in net income per share computation:		
Basic	45,149	46,599
Diluted	46,207	48,044

See accompanying notes to unaudited consolidated financial statements.

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SIMPLETECH, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(unaudited)

	Three Months Ended March 31, 2006	Three Months Ended March 31, 2005
Cash flow from operating activities:		
Net income	$ 1,041	$ 1,036
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	961	696
Loss (gain) on sale of furniture, fixtures and equipment		(6)
Accounts receivable provisions	1,276	886
Inventory excess and obsolescence expense	162	44
Deferred income taxes	(239)	512
Change in operating assets and liabilities:		
Accounts receivable	(6,016)	(1,818)
Inventory	3,349	(14,594)
Other current assets	128	622
Accounts payable	1,907	9,084
Accrued and other liabilities	95	(1,008)
Net cash provided by operating activities	2,664	(4,546)
Cash flows from investing activities:		
Sales of marketable securities, net		7,886
Acquisition of business	(500)	
Purchase of furniture, fixtures and equipment	(938)	(311)
Proceeds from sale of furniture, fixtures and equipment		33
Net cash provided by investing activities	(1,438)	7,608
Cash flows from financing activities:		
Proceeds from exercise of stock options	648	
Tax benefit of employee stock option exercise	198	30
Stock Buyback		(9,489)
Proceeds from issuance of common stock		156
Net cash used in financing activities	846	(9,303)
Net (decrease) increase in cash	2072	(6,241)
Cash and cash equivalents at beginning of period	60,006	73,346
Cash and cash equivalents at end of period	$ 62,078	$ 67,105
Supplemental schedule of noncash investing activities:		
Receivable from Integrated Circuit Solution Incorporation used to fund acquisition	$ 1,000	

See accompanying notes to unaudited consolidated financial statements.

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SIMPLETECH, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 1 Basis of Presentation

The accompanying interim consolidated financial statements of SimpleTech, 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 normal and recurring adjustments considered necessary for a fair statement of the consolidated financial position of the Company at March 31, 2006, the consolidated results of operations for each of the three months ended March 31, 2006 and 2005, and the consolidated results of cash flows for each of the three months ended March 31, 2006 and 2005, 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, 2005 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, 2005. The results for the interim periods are not necessarily indicative of results to be expected for the full year.

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

Reclassifications:

Certain reclassifications have been made to the prior period consolidated financial statements to conform to the current quarter 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,			
	2006		2005	
	Accounts Receivable	Revenues	Accounts Receivable	Revenues
Customer A	27%	22%	25%	19%
Customer B	12%	15%	12%	11%
Customer C	*	13%	11%	18%
Total	39%	50%	48%	48%

* Less than 10%

For each of the three-month periods ended March 31, 2006 and 2005, international sales comprised 13% and 13%, respectively, of the Company s revenues. During these periods, no single foreign country accounted for more than 10% of total revenues. Substantially all of the Company s international sales are export sales, which are shipped from the Company s domestic facility to foreign customers.

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.

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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 amounted to $2.7 million and $2.2 million for each of the three months ended March 31, 2006 and 2005, respectively, of which $2.7 million and $2.0 million, respectively, were offset against revenues, and $10,000 and $160,000, respectively, were charged as an operating expense.

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. The Company estimates the fair value of the benefits it receives by tracking the advertising done by its customers on the Company s behalf and calculating the value of that advertising using a comparable rate for similar publications.

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. For each of the three months ended March 31, 2006 and 2005, shipping and handling costs were $696,000 and $477,000, respectively. Amounts billed to customers for shipping and handling are included in revenues. For each of the three months ended March 31, 2006 and 2005, shipping and handling costs billed to customers were $93,000 and $72,000, respectively.

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, 2006 and 2005 reflects the benefit of tax exempt interest income, the recognition of federal tax credits related to research and development in 2005 increased by the net impact of state taxes in 2006 and decreased by the state benefit related to research and development credits and enterprise zone hiring credits in 2005.

New Accounting Pronouncements:

In November 2004, the Financial Accounting Standards Board (FASB) issued SFAS 151, Inventory Costs , which revised ARB 43, relating to inventory costs. This revision is to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs and wasted material (spoilage). SFAS 151 requires that these items be recognized as a current period charge regardless of whether they meet the criterion specified in ARB 43. In addition, SFAS 151 requires the allocation of fixed production overheads to the costs of conversion be based on normal capacity of the production facilities. SFAS 151 is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. The Company adopted SFAS 151 effective January 2006. The adoption has not had a material impact on its consolidated financial position, results of operations or cash flows.

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In December 2004, the FASB issued SFAS 153, Exchanges of Nonmonetary Assets, which changes the guidance in APB Opinion 29, Accounting for Nonmonetary Transactions . This Statement amends Opinion 29 to eliminate the exception for nonmonetary exchanges of similar productive assets and replaces it with a general exception for exchanges of nonmonetary assets that do not have commercial substance. A nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. SFAS 153 is effective during fiscal years beginning after June 15, 2005. The Company adopted SFAS 153 effective January 2006. The adoption has not had a material impact on its consolidated financial position, results of operations or cash flows.

In June 2005, the FASB issued SFAS 154, Accounting Changes and Error Corrections a replacement of APB No. 20 and FAS No. 3 . SFAS 154 provides guidance on the accounting for and reporting of accounting changes and error corrections. It establishes, unless impracticable, retrospective application as the required method for reporting a change in accounting principle in the absence of explicit transition requirements specific to the newly adopted accounting principle. SFAS 154 also provides guidance for determining whether retrospective application of a change in accounting principle is impracticable and for reporting a change when retrospective application is impracticable. The correction of an error in previously issued financial statements is not an accounting change. However, the reporting of an error correction involves adjustments to previously issued financial statements similar to those generally applicable to reporting an accounting change retrospectively. Therefore, the reporting of a correction of an error by restating previously issued financial statements is also addressed by SFAS 154. SFAS 154 is required to be adopted in fiscal years beginning after December 15, 2005. The Company adopted SFAS 154 effective January 2006. The adoption has not had a material impact on its consolidated financial position, results of operations or cash flows.

In February 2006, the FASB issued Statement of Financial Accounting Standards No. 155, Accounting for Certain Hybrid Financial Instruments an amendment of FASB Statements No. 133 and 140 which is effective for fiscal years beginning after September 15, 2006. The statement was issued to clarify the application of FASB Statement No. 133 to beneficial interests in securitized financial assets and to improve the consistency of accounting for similar financial instruments, regardless of the form of the instruments. The Company is currently evaluating the new statement to determine the potential impact, if any, this would have on the Company s financial results.

In March 2006, the FASB issued Statement of Financial Accounting Standards No. 156, Accounting for Servicing of Financial Assets an amendment of FASB Statement No. 140 which is effective for fiscal years beginning after September 15, 2006. This statement was issued to simplify the accounting for servicing rights and to reduce the volatility that results from using different measurement attributes. The Company has evaluated the new statement and has determined that it will not have a significant impact on the determination or reporting of the Company s financial results.

Note 3 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 $1,500,000. 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 not finalized and the preliminary 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	$ 0
Fixed assets	1,050
Fair value of tangible assets acquired	1,050
Goodwill	450
Consideration	1,500

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Note 4 Net Income (Loss) Per Share

Basic earnings per share is computed by dividing net income (loss) 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 9,996,441 and 9,581,744 shares of common stock were outstanding at March 31, 2006 and 2005, respectively. For each of the three months ended March 31, 2006 and 2005, potentially dilutive securities consisted solely of options and resulted in potential common shares of 1,058,028 and 1,444,610, respectively.

Stock-Based Compensation

On January 1, 2006, the Company adopted SFAS 123(R), Share-Based Payment , which was issued in December 2004. SFAS 123(R) is a revision to SFAS 123, Accounting for Stock-Based Compensation , and supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees and its related interpretations. SFAS 123(R) 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 cost will be recognized over the period during which an employee is required to provide service in exchange for the award. No compensation cost is recognized for equity instruments for which employees do not render service. The Company adopted SFAS No. 123R using the modified prospective method. Accordingly, prior period amounts have not been restated. Under this application, the Company is required to record compensation expense for all awards granted after the date of adoption and for the unvested portion of previously granted awards that remain outstanding at the date of adoption.

On December 19, 2005, the Company s board of directors approved the termination of its Employee Stock Purchase Plan (ESPP) and the acceleration of the vesting of all then current unvested stock options awarded under its 2000 Stock Incentive Plan, including stock options held by its employees, officers, directors and consultants. These unvested stock options consist of both in-the-money as well as out-of-the-money options. Based upon the closing price of SimpleTech common stock of $3.79 per share on December 19, 2005, approximately 47% of the total accelerated stock options were in-the-money with a weighted average exercise price of $3.20 per share. In accordance with SFAS 123, the Company expensed the remaining unrecognized compensation cost associated with the options with accelerated vesting in the pro forma disclosure. The decision to terminate the ESPP and accelerate vesting of the stock options was made primarily to avoid recognizing the related compensation expense in the Company s future consolidated financial statements with respect to the shares issued under the ESPP and the unvested stock options upon the Company s adoption of Statement SFAS 123(R) on January 1, 2006. As a result of adopting FAS 123(R) on January 1, 2006, the Company s share based compensation expense was $2,000 for the three months ended March 31, 2006.

Prior to the adoption of SFAS 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 Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation (SFAS 123). Under the intrinsic value method, no stock-based compensation expense had been recognized in the Company s consolidated statement of operations because the exercise price of the Company s stock options granted to employees and directors equaled the fair market value of the underlying stock at the date of grant.

For purposes of pro forma disclosures, the estimated fair value of the options is amortized to expense over the options vesting period. The table below sets forth the Company s pro forma information for the three months ended March 31, 2005, assuming the Company had determined compensation cost for awards under stock option plans based on the fair value at the grant date.

	Three Months Ended March 31, 2005	
Net income, as reported	$	1,036
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects		(928)
Pro forma net income	$	108
Income per share:		
Basic as reported	$	0.02
Basic pro forma	$	0.00

Diluted as reported	$	0.02
Diluted pro forma	$	0.00

For purposes of the foregoing pro forma illustration, the fair value method for the options was estimated at the date of grant using the Black-Scholes option-pricing model.

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Note 5 Supplemental Balance Sheet Information

Inventory consists of the following:

(in thousands)	March 31, 2006	December 31, 2005
Raw materials	$ 20,954	$ 22,994
Work-in-progress	2,885	1,132
Finished goods	11,397	14,938
	35,236	39,064
Valuation allowances	(1,640)	(1,956)
Inventory, net	$ 33,596	$ 37,108

Accrued and other liabilities consisted of the following as of:

(in thousands)	March 31, 2006	December 31, 2005
Payroll costs	$ 3,632	$ 3,423
Marketing	639	2,148
Other	3,019	1,624
Total	$ 7,290	$ 7,195

Note 6 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

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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.

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.

Indemnification

The Company has agreements whereby the Company indemnifies its officers and directors over his or her lifetime for certain events or occurrences while the officer or director is, or was serving, at the Company s request in such capacity. The maximum potential amount of future payments the Company could be required to make under these indemnification agreements is unlimited; however, the Company has a Director and Officer insurance policy that limits the Company s exposure and should enable the Company to recover a portion of any future amounts paid. As a result of the Company s insurance policy coverage, the Company believes the estimated potential liability related to these indemnification agreements is minimal. All of these indemnification agreements, except for the agreement for James Peterson and Rajat Bahri who joined the Board of Directors in January 2003 and November 2005, respectively, were grandfathered under the provisions of Financial Accounting Standards Board interpretation (FIN) No. 45, Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others an Interpretation of FASB Statements No. 5, 57 and 107 and Rescission of FASB Interpretation No. 34, as they were in effect prior to December 31, 2002. Accordingly, the Company has no liabilities recorded for these agreements as of March 31, 2006.

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 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, 2006.

Other Commitments

The Company is subject to repurchase agreements with various financial institutions in connection with wholesale inventory financing. Under these agreements, the Company may be required to repurchase inventory upon customer default with a financing institution and then resell the inventory through normal distribution channels. As of March 31, 2006, the Company has not been required to repurchase inventory in connection with the customer default agreements noted above. However, it may be possible that the Company will be required to repurchase inventory, upon customer default, in the future. Sales under such agreements were approximately $184,000 and $524,000 in each of the three months ended March 31, 2006 and 2005, respectively.

Note 7 Segment Information

The Company reports financial results for two reportable operating segments: OEM and Consumer Divisions. The Company does not aggregate any operating segments.

The accounting policies for each of the reportable operating segments are the same as those described in Note 2 from the Company s Annual Report on Form 10-K for the year ended December 31, 2005 and reflect the information used by the Company s management to evaluate the performance of its segments. For the OEM and Consumer segments, the Company tracks separately net sales and gross profit, but does not track separately operating expenses. The Company does not maintain separate records to identify assets by operating segment.

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Summarized financial information regarding the Company s two reportable segments is shown in the following table:

(In Thousands)

	Three Months Ended March 31, 2006		
	Net Revenues	Cost of Revenues	Gross Profit
Consumer:			
Standard Memory	$ 10,019	$ 8,460	$ 1,559
Flash Memory	$ 4,264	$ 3,869	$ 395
Stacked Memory	$ 910	$ 782	$ 128
Hard Drive	$ 9,865	$ 8,444	$ 1,421
	$ 25,058	$ 21,555	$ 3,503
OEM:			
Standard Memory	$ 5,432	$ 4,590	$ 842
Flash Memory	$ 16,801	$ 10,907	$ 5,894
Stacked Memory	$ 18,115	$ 15,726	$ 2,389
Other	$ 85	$ 41	$ 44
	$ 40,433	$ 31,264	$ 9,169
TOTAL:			
Standard Memory	$ 15,451	$ 13,050	$ 2,401
Flash Memory	$ 21,065	$ 14,776	$ 6,289
Stacked Memory	$ 19,025	$ 16,508	$ 2,517
Hard Drive/other	$ 9,950	$ 8,485	$ 1,465
	$ 65,491	$ 52,819	$ 12,672

	Three Months Ended March 31, 2005		
	Net Revenues	Cost of Revenues	Gross Profit
Consumer:			
Standard Memory	$ 18,544	$ 16,518	$ 2,026
Flash Memory	$ 8,593	$ 7,722	$ 871
Stacked Memory	$ 1,975	$ 1,498	$ 477
Hard Drive	$ 5,219	$ 4,157	$ 1,062
	$ 34,331	$ 29,895	$ 4,436
OEM:			
Standard Memory	$ 5,721	$ 4,625	$ 1,096
Flash Memory	$ 4,906	$ 2,685	$ 2,221
Stacked Memory	$ 16,030	$ 12,941	$ 3,089
Other	$ 259	$ 118	$ 141
	$ 26,916	$ 20,369	$ 6,547
TOTAL:			
Standard Memory	$ 24,265	$ 21,143	$ 3,122
Flash Memory	$ 13,499	$ 10,407	$ 3,092

Stacked Memory	$ 18,005	$ 14,439	$ 3,566
Hard Drive/other	$ 5,478	$ 4,275	$ 1,203
	$ 61,247	$ 50,264	$ 10,983

Note 8 Intangible Assets

The following table presents detail of the Company s Intangible assets, related accumulated amortization and goodwill:

	As of March 31, 2006			As of December 31, 2005		
	Gross	Accumulated Amortization	Net	Gross	Accumulated Amortization	Net
Developed technology (five years)	$ 400,000	$ 127,000	$ 273,000	$ 400,000	$ 107,000	$ 293,000
Customer relationships (five years)	900,000	198,000	702,000	900,000	157,000	743,000
Total	$ 1,300,000	$ 325,000	$ 975,000	$ 1,300,000	$ 264,000	$ 1,036,000
Goodwill	$ 1,682,000	$ 0	$ 1,682,000	$ 733,000	$ 0	$ 733,000

In accordance with SFAS 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. The increase of $949,000 in goodwill is the result of $450,000 related to the acquisition of the flash controller group of the logic division of Integrated Circuit Solution Incorporation on January 15, 2006 and due to the Company determining the final tax liability of $499,000 related to the July 13, 2005 acquisition of Memtech SSD Corporation. This tax liability related to Memtech s fiscal year ended June 30, 2005 and was recorded to goodwill in the first quarter of 2006. Intangible assets with finite lives continue to be subject to amortization, and any impairment is determined in accordance with SFAS 144, Accounting for the Impairment or Disposal of Long-Lived Assets. The Company recorded amortization expense for the three months ended March 31, 2006 of $62,000 and for the three months ended March 31, 2005 of $20,000. Estimated intangible asset amortization expense (based on existing intangible assets) for the years ending December 31, 2006, 2007, 2008, 2009 and 2010 is $245,000, $245,000, $245,000, $218,000, and $83,000, respectively. Amortization is complete as of the end of 2010.

Note 9 Shareholders Equity

The 2000 Stock Incentive Plan (the Plan) was adopted by the Company s board of directors and approved by its shareholders in June 2000. The Plan provides for the direct 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. The compensation committee of the Company s board of directors has the authority to determine the time or times at which options become exercisable under the Plan. Options expire within a period of not more than ten years from the date of grant.

At March 31, 2006, the Plan provided for the issuance of up to 17,226,645 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.

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

	Shares	Weighted-Avg Option Price
Outstanding, December 31, 2005	10,452,888	$ 4.93
Granted	25,000	4.16
Exercised	(325,114)	2.58
Forfeited/Expired	(131,333)	6.37
Outstanding, March 31, 2006	10,021,441	4.30

Exercisable, March 31, 2006	9,996,441	4.30

The Company received $646,000 in cash proceeds for the exercise of 325,114 options with a $476,000 tax benefit for disqualifying dispositions of incentive stock options. The intrinsic value for options exercised for the three months ended March 31, 2006 was $512,000.

As of March 31, 2006, total unrecognized compensation expense related to unvested share-based compensation arrangements already granted under our stock option plan was $65,000, which we expect will be recognized over a weighted-average period of 3.9 years.

The total aggregate intrinsic value of stock options outstanding, exercisable and in the money at March 31, 2006 was $3,272,000.

At March 31, 2006, 3,414,767 options were available for grant under the Plan.

	Options Outstanding			Exercisable	
Range of Exercise Prices	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Life (Years)	Number of Shares	Weighted Average Exercise Price
$1.06 to $2.20	466,675	$ 1.24	0.83	466,675	$ 1.24
$2.20 to $3.30	2,446,153	3.01	6.87	2,446,153	3.01
$3.30 to $5.50	4,341,652	4.04	8.70	4,316,652	4.03
$5.50 to $6.60	1,966,161	5.78	6.36	1,966,161	5.78
$6.60 to $11.00	800,800	8.15	8.23	800,800	8.15
	10,021,441			9,996,441	

The fair value of each option grant has been estimated on the date of grant using the Black-Scholes option pricing model with the following weighted-average assumptions for the grants at March 31, 2006:

Assumptions	March 31, 2006
Dividend Yield	0.00%
Risk-Free Interest Rate	4.58%
Volatility	84.02%
Expected Life (Years)	5.8
Weighted Average Fair Value of Grants	$2.19

The Company has not and does not expect to pay dividends, therefore, no specific dividend yield is utilized under the Black-Scholes option pricing model. The risk-free interest rate assumption is based upon observed interest rates appropriate for the term of the Company s employees stock option grants. The volatility assumption used to value option grants is based exclusively on the Company s historical available closing stock price information. The Company can rely exclusively on this historical information if (1) the Company has no reason to believe that its future volatility over the expected or contractual term is likely to differ from the past, (2) the computation of historical volatility uses a simple average calculation method, (3) a sequential period of historical data at least equals the expected or contractual term of the share options is used and (4) a reasonably sufficient number of price observations are used. The expected life of employee stock options represents the historical weighted-average period the stock options are expected to remain outstanding. The expected life of employees stock option grants are impacted by all of the underlying assumptions used in the Company s model. The Black-Scholes option pricing model assumes that employees exercise behavior is a function of the options remaining contractual life and the extent to which the option is in-the-money. The Black-Scholes option pricing model estimates the probability of exercise as a function of these two variables based on the history of exercises and cancellations of past option grants made by the Company.

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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.

Overview

SimpleTech, Inc. was originally incorporated in California in March 1990 as Simple Technology, Inc. Our name was then changed to SimpleTech, Inc. in May 2001. SimpleTech designs, develops, manufactures and markets custom and 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 sell our products through our Consumer and OEM Divisions. Our Consumer Division sells our products through a variety of distribution channels, including VARs, mail order, distributors, and mass market retailers. Our OEM Division markets our products to OEMs, leveraging our custom design capabilities to offer custom memory solutions to address their specific needs.

We are focusing on several revenue growth initiatives, including:

- Developing and qualifying customized OEM Flash-based products, including our Zeus product line, for industrial applications;

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

- Increasing retail sales of our storage product line; 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 form factors. We expanded our OEM Flash business through our acquisition on July 13, 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 a division of Integrated Circuit Solution Inc., a Taiwanese company, and added a team of engineers in Taiwan specializing in Flash controller design. We believe that our continued investment in this area will positively impact the future growth of our OEM Flash revenues.

OEM Flash product revenue increased 243% from $4.9 million in the first quarter of 2005 to $16.8 million in the first quarter of 2006. We expect continued revenue growth from our OEM Flash product line in 2006. OEM Flash product gross margins are typically significantly higher than our Consumer Flash product gross margins and were our highest gross margin product line in each of the first quarters of 2006 and 2005.

We offer monolithic DRAM memory modules and DRAM memory modules based on our stacking technology. The majority of our Consumer DRAM business has been comprised of monolithic DRAM memory modules. Prior to 2005, the substantial majority of our OEM DRAM business has 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 stacked DRAM memory module revenues have been

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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.

In the past few years, we have invested in the design, development and launch of our product line of 3.5 , 3.5 NAS, 2.5 and 1 Consumer external storage drives. As a result of our penetration into numerous major U.S. retailers in the past year, we believe this product line is gaining momentum. Our external storage product revenue increased from $5.2 million in the first quarter of 2005 to $9.9 million in the first quarter of 2006. We expect to increase our presence in the external storage market through the anticipated launch of our storage solutions at two major retailers in the second and third quarters of 2006.

We continue to make progress toward one of our long-term revenue growth initiatives to expand of our international business in Asia and Europe. Since the beginning of 2004, we have opened sales, marketing, procurement and engineering offices in France, Hong Kong, Japan, the Netherlands and Taiwan in order to build the necessary infrastructure to support revenue growth in those geographic regions.

Gross profit as a percentage of revenues for our OEM Division is typically higher than our Consumer Division. We track revenues and gross margins for our Consumer and OEM Divisions. We do not track separately, and do not intend to track separately, operating expenses for our Consumer and OEM Divisions.

Historically, a limited number of customers have accounted for a significant percentage of our revenue. Our ten largest customers accounted for an aggregate of 70.0% of our total revenues in the first three months of 2006, compared to 68.1% of our total revenues in the first three months of 2005. Smart Modular, Micron Semiconductor and CDW Logistics, Inc. (formerly CDW Computer Centers), accounted for 22.2%, 14.7% and 12.5%, respectively, of our total revenues in the first three months of 2006. Smart Modular, CDW Logistics, Inc. and Hewlett Packard accounted for 19.1%, 17.8% and 10.5%, respectively, of our total revenues in the first three months of 2005. Other than Smart Modular, Micron Semiconductor, CDW Logistics, Inc. and Hewlett Packard, no other customer accounted for more than 10.0% of our total revenues in each of the first three months of 2006 or 2005. 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 12.7% of our revenues in the first three months of 2006, compared to 12.5% of our revenues in the first three months of 2005. No foreign geographic area or single foreign country accounted for more than 10.0% of our revenues in each of the first three months of 2006 or 2005. For each of the first three months ended March 31, 2006 and 2005, 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 be, impacted by seasonal purchasing patterns resulting in lower sales in the first and second quarters of each year. Other factors, including component price fluctuations, may distort the effect of seasonality. Our ability to adjust our short-term operating expenses in response to fluctuations in revenues is limited. As a result, should revenues decrease to a level lower than expected in any given period, our results of operations would be harmed.

On January 1, 2006, we adopted SFAS 123(R), Share-Based Payment , which was issued in December 2004. SFAS 123(R) is a revision to SFAS 123, Accounting for Stock-Based Compensation , and supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees and its related interpretations. SFAS 123(R) 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 cost will be recognized over the period during which an employee is required to provide service in exchange for the award. Prior to our adoption of SFAS 123(R), we accounted for employee stock options for financial and accounting purposes under APB No. 25, which does not require the expensing of stock options until they are exercised.

On December 19, 2005, our board of directors terminated our Employee Stock Purchase Plan, or ESPP, and approved the acceleration of the vesting of all then current unvested stock options awarded under our 2000 Stock Incentive Plan, including options held by our employees, officers, directors and consultants. All other terms and conditions applicable to such stock options, including the exercise prices, remain unchanged. The decision to terminate the ESPP and accelerate vesting of the stock options was made primarily to avoid recognizing the related compensation expense in our future consolidated financial statements with respect to the shares issued under the ESPP and the unvested stock options upon our adoption of SFAS 123(R) on January 1, 2006. As a result of our adoption of SFAS No. 123R, we are required to record compensation expense for all awards granted on and after January 1, 2006 and for the unvested portion of previously granted awards that remain outstanding as of December 31, 2005. We had outstanding unvested stock options to purchase an aggregate of 25,000 shares of common stock at

March 31, 2006 and no outstanding unvested stock options as of December 31, 2005. For the three months ended March 31, 2006, we recorded stock-based compensation expense of $2,000 consisting of expenses related to employee stock options which is included in research and development expenses. As of March 31, 2006, total unrecognized compensation expense related to unvested share-based compensation arrangements already granted under our stock option plan was $65,000, which we expect will be recognized over a weighted-average period of 3.9 years. We believe SFAS 123(R) will increase our compensation expense, could make our operating results less predictable and affect the way we compensate our employees or cause other changes in the way we conduct our business. As a result of our adoption of SFAS 123(R), 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. See Notes 4 and 9 to our unaudited consolidated financial statements for additional information concerning our adoption of SFAS 123(R) and our stock incentive plan.

Results of Operations

The following table sets forth, for the periods indicated, certain consolidated statement of operations data reflected as a percentage of revenues.

	Three Months Ended March 31,	
	2006	**2005**
Net revenues	100.0%	100.0%
Cost of revenues	80.7	82.1
Gross profit	19.3	17.9
Operating expenses		
Sales and marketing	9.0	8.8
General and administrative	5.5	5.0

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	Three Months Ended March 31, 2006	2005
Research and development	3.1	2.1
Total operating expenses	17.6	15.9
Operating income	1.7	2.0
Interest income	0.7	0.7
Income before provision for income taxes	2.4	2.7
Net income	1.6	1.7

Comparison of Three Months Ended March 31, 2006 Compared to Three Months Ended March 31, 2005

Net Revenues. Our revenues were $65.5 million in the first quarter of 2006, compared to $61.2 million in the same period in 2005. Revenues increased 7.0% in the first quarter of 2006 due primarily to a 20% increase in unit shipments, partially offset by a 11% decrease in average sales price, or ASP, from $61 in the first quarter of 2005 to $54 in the first quarter of 2006. The decrease in our ASP resulted primarily from declining DRAM and Flash component prices. The increase in unit shipments resulted primarily from a 518% increase in OEM Flash memory units shipped and a 37 % increase in Consumer external storage units shipped, partially offset by a 45% decrease in Consumer standard DRAM and a 36% decrease in Consumer Flash memory units shipped. OEM Flash product shipments increased from 80,000 units in the first quarter of 2005 to 498,000 units in the first quarter of 2006. Consumer external storage product shipments increased from 80,000 units in the first quarter of 2005 to 109,000 units in the first quarter of 2006.

Our Consumer Division revenues decreased 26.8% from $34.3 million in the first quarter of 2005 to $25.1 million in the first quarter of 2006. Consumer Division revenues decreased in the first quarter of 2006 due to a 32% decrease in units shipped, partially offset by a 9% increase in ASP from $43 in the first quarter of 2005 to $47 in the first quarter of 2006. The decrease in Consumer Division units shipped resulted primarily from a 45% decrease in Consumer standard DRAM and a 36% decrease in Consumer Flash memory units shipped. The increase in ASP resulted primarily from a positive mix shift toward higher-ASP external storage products.

Our OEM Division revenues increased 50.2% from $26.9 million in the first quarter of 2005 to $40.4 million in the first quarter of 2006. The increase in OEM Division revenues was due to a 205% increase in OEM Division units shipped, partially offset by a 50.8% decrease in ASP from $122 in the first quarter of 2005 to $60 in the first quarter of 2006. The increase in OEM Division unit volume resulted primarily from an increase in Flash memory units shipped from 80,000 units in the first quarter of 2005 to 498,000 units in the first quarter of 2006 and an increase in stacked DRAM units shipped from 75,000 units in the first quarter of 2005 to 100,000 units in the first quarter of 2006. The decrease in our OEM Division ASP resulted primarily from a significant shift in product mix toward lower-ASP, lower-capacity (but higher gross margin), Flash memory products.

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 combined backlog was $19.9 million as of March 31, 2006, compared to $14.0 million as of March 31, 2005. Our Consumer Division backlog was $5.6 million as of March 31, 2006, compared to $3.4 million as of March 31, 2005. Our OEM Division backlog was $14.3 million as of March 31, 2006, compared to $10.6 million as of March 31, 2005. The increase in backlog at March 31, 2006 compared to March 31, 2005 was due to increased orders primarily for our OEM Flash and Consumer retail product lines in the first quarter of 2006. 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 $12.7 million in the first quarter of 2006, compared to $11.0 million in the same period in 2005. Gross profit as a percentage of revenues was 19.3% in the first quarter of 2006, compared to 17.9% in the first quarter of 2005. Gross profit as a percentage of revenue in the first quarter of 2006 increased due primarily to a shift in product mix toward higher gross profit margin OEM products. Gross profit for our Consumer Division as a percentage of Consumer Division revenues increased from 12.9% in the first quarter of 2005 to 14.0% in the first quarter of 2006, resulting primarily from the elimination of sales to certain low gross margin, unprofitable customers. Gross profit for our OEM Division as a percentage of OEM Division revenues decreased from 24.3% in the first quarter of 2005 to 22.7% in the first quarter of 2006. This decrease in gross profit as a percentage of revenues for our OEM Division resulted primarily from a decrease in OEM

Flash product gross profit margin from 45.3% in the first quarter of 2005 to 35.1% in the first quarter of 2006 as we significantly expanded revenues from this product line.

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 $5.9 million in the first quarter of 2006, compared to $5.4 million in the first quarter of 2005. Sales and marketing expenses as a percentage of revenue were 9.0% in the first quarter of 2006, compared to 8.8% in the first quarter of 2005. The increase in sales and marketing expenses in absolute dollars and as a percentage of revenue was due primarily to an increase in commissions paid and shipping expenses as a result of a higher revenue level and the addition of sales and marketing personnel hired to execute on our revenue growth initiatives such as revenue expansion in Asia and to support the continued expansion of our OEM Flash products and our Consumer external storage products in the retail channel. 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 $3.6 million in our first quarter of 2006, compared to $3.1 million in the first quarter of 2005. General and administrative expenses as a percentage of revenues were 5.5% in the first quarter of 2006, compared to 5.0% in the first quarter of 2005. The increase in general and administrative expenses in absolute dollars and as a percentage of revenue was due primarily to an increase in bad debt expense, additional payroll expense and severance costs.

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 $2.0 million in the first quarter of 2006, compared to $1.3 million in the first quarter of 2005. Research and development expenses as a percentage of revenues were 3.1% in the first quarter of 2006, compared to 2.1% in the first quarter of 2005. Research and development expenses increased due primarily to an increase in payroll costs from our expanding global research and development efforts related to our OEM Flash product line.

Interest Income, Net. Interest income, net was $475,000 in the first quarter of 2006 and $435,000 in the first quarter of 2005. 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 in the first quarter of 2006 compared to the first quarter of 2005.

Provision for Income Taxes. The provision for income taxes decreased from $637,000 in the first quarter of 2005 to $529,000 in the first quarter of 2006. As a percentage of income before provision for income taxes, provision for income taxes decreased from 38% in the first quarter of 2005 to 34% in the first quarter of 2006, due primarily to an increase in tax exempt interest income in the first quarter of 2006 which was primarily due to an increase in interest rates, offset by the expiration of the research and development credit on December 31, 2005.

Net Income. Net income was $1.0 million in the first quarter of 2006, compared to $1.0 million in the first quarter of 2005.

Liquidity and Capital Resources

Working Capital, Cash and Marketable Securities

As of March 31, 2006, we had working capital of $112.8 million, including $62.1 million of cash and cash equivalents, compared to working capital of $113.2 million, including $60.0 million of cash and cash equivalents as of December 31, 2005, and working capital of 114.3 million, including $67.1 million of cash and cash equivalents and $2.0 million in marketable securities as of March 31, 2005. Current assets were 4.8 times current liabilities at March 31, 2006, compared to 5.1 times current liabilities at December 31, 2005, and 4.8 times current liabilities at March 31, 2005.

Cash Provided in Operating Activities in the First Quarters of 2006 and 2005

Net cash provided by operating activities was $2.7 million for the first quarter of 2006 and resulted primarily from a $1.9 million increase in accounts payable, net income of $1.0 million, non-cash depreciation and amortization of $1.0 million and a $3.5 million decrease in inventory, net of reserves, partially offset by a $4.7 million increase in accounts receivable, net of allowances. Accounts receivable, net of allowances, increased primarily due to an increase in sales for the OEM Division Flash product line orders and the continued growth of our external storage product line in the retail channel. Net cash used in operating activities was $4.5 million for the first quarter of 2005 and resulted primarily from a $14.6 million increase in inventory, net of reserves, and a $932,000 increase in accounts receivable, net of allowances, offset by a $9.1 million increase

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in accounts payable. Inventory, net of reserves, increased as a result of increased OEM Division orders, along with the anticipation of the nationwide launch of our external storage product line in the second quarter of 2005.

Cash Used in Investing Activities in the First Quarters of 2006 and 2005

Net cash used by investing activities was $1.4 million for the first quarter of 2006, 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. Net cash provided by investing activities was $7.6 million for the first quarter of 2005, attributable to $7.9 million of redemptions of marketable securities and $311,000 in purchases of furniture, fixtures and equipment. We expect to spend approximately $4.0 to $6.0 million on capital expenditures during the next 24 months, primarily for the purchase of manufacturing, testing and engineering equipment.

Cash Provided in Financing Activities in the First Quarters of 2006 and 2005

Net cash provided by financing activities was $846,000 for the first quarter of 2006 and resulted from $648,000 of proceeds realized from the exercise of stock options and a $198,000 tax benefit from employee stock option exercises. Net cash used by financing activities was $9.3 million for the first quarter of 2005 and resulted primarily from the $9.5 million repurchase of our common stock under our stock buy back plan, partially offset by the issuance of common stock for proceeds of $156,000 related to our employee stock purchase plan and stock option exercises.

In June 2004, our board of directors authorized the purchase of up to $15 million of our outstanding common stock from time to time over the next 18 months. We repurchased 3,045,886 shares of common stock at an average share price of $3.88, including commissions, in 2005, and 841,509 shares of common stock at an average share price of $3.68, including commissions, in 2004. The share repurchase plan expired on December 16, 2005. Repurchased shares were returned to the status of authorized but unissued shares of common stock and may be issued by us in the future.

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 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;
- the levels of promotion and advertising that will be required to launch our new products and achieve and maintain a competitive position in the marketplace;
- 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

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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, 2006. We do not have off-balance sheet financing arrangements as of March 31, 2006.

	Payment due by period				
Contractual Obligation	**Total**	**Less than 1 year**	**1-3 years**	**3-5 years**	**More than 5 years**
Operating Lease Obligations	$ 8,191,000	$ 1,157,000	$ 1,787,000	$ 1,298,000	$ 3,949,000
Non-cancelable capital equipment purchase commitments	$ 112,000	$ 112,000	$	$	$
Non-cancelable inventory purchase commitments	$ 21,003,000	$ 21,003,000	$	$	$
Other non-cancelable purchase commitments	$ 1,658,000	$ 1,658,000	$	$	$
Total	$ 30,964,000	$ 23,930,000	$ 1,787,000	$ 1,298,000	$ 3,949,000

Inflation

Inflation was not a material factor in either revenue or operating expenses during each of the first three months ended March 31, 2006 and 2005.

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.

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. We offer a majority of our customers that purchase products through our consumer channels limited rights to return unsold 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 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*

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Given by a Vendor to a Customer (Including a Reseller of the Vendor s Products) . Sales and marketing incentives amounted to $2.7 million and $2.2 million for each of the three months ended March 31, 2006 and 2005, respectively, of which $2.7 million and $2.0 million, respectively, were offset against revenues, and $10,000 and $160,000, respectively, were charged as an operating expense. 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. We estimate the fair value of the benefits we receive by tracking the advertising done by our customers on our behalf and calculating the value of that advertising using a comparable rate for similar publications.

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.

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.

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.

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, 2006, our cash and cash equivalents were $62.1 million invested in money market and other interest bearing accounts.

From time to time, we invest in marketable securities, however, at March 31, 2006, 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 $621,000. 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.

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The carrying amount, principal maturity and estimated fair value of our cash and cash equivalents as of March 31, 2006 were as follows:

	Expected Maturity Date Before April 1, 2007	Thereafter	Total	Fair Value 3/31/2006
Investments				
Cash and cash equivalents:				
Money Market Funds	$ 62,078,000	$ 0	$ 62,078,000	$ 62,078,000
Weighted average interest rate	3.08%		3.08%	3.08%
Total cash and cash equivalents	$ 62,078,000	$ 0	$ 62,078,000	$ 62,078,000
Weighted average interest rate	3.08%		3.08%	3.08%

Foreign Currency Exchange Rate Risk

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 DRAM and Flash 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.

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,

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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 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 or fluctuations in the cost of such components;
- Fluctuating market demand for, 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;
- Seasonal purchasing patterns for our Consumer Division products with lower sales generally occurring in the first and second quarters followed by higher sales in the fourth quarter of each year;
- 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;

Order cancellations, product returns, inventory write-downs, price protections, and rebates;

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 future rapid growth;

Our ability to absorb manufacturing overhead;

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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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 90% of the component costs of our manufactured Flash cards and DRAM modules. We are dependent on a small number of suppliers that supply Flash and DRAM components. We have no long-term DRAM or Flash IC device supply contracts. Some of our competitors have entered into long-term contracts with suppliers that guarantee them a certain allocation of Flash IC devices. We have no assurance that our existing suppliers will agree to supply the quantities of Flash IC devices 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. 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. Samsung currently supplies substantially all of the IC devices used in our Flash memory products. Elpida, Infineon Technologies and Samsung currently supply a majority of the DRAM IC devices used in our DRAM and IC Tower stacking DRAM memory products. In addition, Western Digital and Bell Microproducts currently supply a majority of the raw hard drives used in our external storage products. 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 Bell Microproducts, Elpida, Infineon Technologies and Samsung are disrupted or terminated, our ability to manufacture and sell our DRAM and Flash products would be harmed and our business would be adversely affected.

Ineffective management of inventory levels or product mix, order cancellations, product returns, inventory write-downs, price protection and rebates 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 our Consumer Division customers are unable to sell their inventory in a timely manner, we may choose or be required to lower the price of our products or allow our customers to exchange the slow-moving products for newer products. Similarly, 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. A majority of our sales through commercial channels include limited rights to return unsold 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. In addition, some of our inventory is sold on a consignment basis, and we have very little ability to control or manage that inventory. 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. These inventory write-downs were $479,000 in the first quarter of 2006, compared to $44,000 in the first quarter of 2005. In addition, we offer some of our Consumer Division customers limited price protection rights for inventories of our products held by them. If we reduce the list price of our products, these customers may receive credits from us. We incurred price protection charges of $738,000 in the first quarter of 2006, compared to $581,000 in the first quarter of 2005. We also offer rebate programs through some of our Consumer Division customers to end-users. We incurred rebate charges of $717,000 in the first quarter of 2006, compared to $125,000 in the first quarter of 2005. Rebate charges increased significantly in the first quarter of 2006 compared to the first quarter of 2005 due primarily to the expansion of our revenues from the retail channel, which typically involves the frequent use of rebate programs.

We are also subject to repurchase agreements with various financial institutions in connection with wholesale inventory financing. Under these agreements, we may be required to repurchase inventory upon customer default with a financing institution and then resell the inventory through normal distribution channels. As of March 31, 2006, we have never been required to repurchase inventory in connection with the customer default agreements noted above. However, it may be possible that we will be required to repurchase inventory, upon customer default, in the future. Sales under such agreements were approximately $184,000 in the first quarter of 2006, compared to $524,000 in the first quarter of 2005.

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

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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 memory component market has 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. Declines in average sales prices would also enable OEMs to pre-install higher capacity base memory into new systems at existing price points, and thereby reduce the demand for our aftermarket memory products. 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 retail consumer chains, 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. Historically, a relatively limited number of customers have accounted for a significant percentage of our revenues. Our ten largest customers accounted for an aggregate of 70.0% of our total revenues in the first quarter of 2006, compared to 68.1% of our total revenues in the first quarter of 2005. Our ten largest Consumer Division customers accounted for an aggregate of 76.6% of our Consumer Division revenues, or 29.3% of our total revenues, in the first quarter of 2006, compared to 69.3% of our Consumer Division revenues, or 38.8% of our total revenues, in the first quarter of 2005. The following table sets forth certain information about our Consumer Division customer that accounted for more than 10.0% of our total revenues in each of the three months ended March 31, 2006 and 2005.

	Three Months Ended March 31, 2006		Three Months Ended March 31, 2005	
Consumer Division Customer(s)	**% of Total Revenues**	**% of Consumer Division Revenues**	**% of Total Revenues**	**% of Consumer Division Revenues**
CDW Logistics, Inc. (formerly CDW Computer Centers)	12.5%	32.7%	17.8%	31.8%

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Our ten largest OEM Division customers accounted for an aggregate of 78.8% of our OEM Division revenues, or 48.7% of our total revenues, in the first quarter of 2006, compared to 86.4% of our OEM Division revenues, or 38.0% of our total revenues, in the first quarter of 2005. The following table sets forth certain information about each of our OEM Division customers that accounted for more than 10.0% of our total revenues in each of the three months ended March 31, 2006 and 2005.

	Three Months Ended March 31, 2006		Three Months Ended March 31, 2005	
OEM Division Customer(s)	**% of Total Revenues**	**% of OEM Division Revenues**	**% of Total Revenues**	**% of OEM Division Revenues**
Smart Modular	22.2%	36.0%	19.1%	43.3%
Micron Semiconductor	14.7%	23.8%	*	*
Hewlett Packard	*	*	10.5%	18.9%

* Data not provided since customer represented less than 10% of total revenues.

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, consumer electronics 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 France, Hong Kong, Japan, the Netherlands and Taiwan.

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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
- 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.

New accounting and financial reporting requirements, including new standards that affect how we account for equity compensation, may impact our financial results.

We prepare our financial statements in conformity with accounting principles generally accepted in the United States of America. These principles are subject to interpretation by the Securities and Exchange Commission and various bodies formed to interpret and create appropriate accounting policies. A change in these policies could significantly impact our reported results and could retroactively affect previously reported transactions.

Historically, we have accounted for employee stock options for financial and accounting purposes under Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees , which does not require the expensing of stock options until they are exercised. In December 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting No. 123(R), which amended financial accounting standards and require that awards under such plans be treated as compensation expense using the fair value method. On April 14, 2005, the U.S. Securities and Exchange Commission adopted a new rule amending the compliance dates for SFAS 123(R). In accordance with the new rule, the accounting provisions of SFAS 123(R) is effective for fiscal 2006. We believe this revised standard will increase our compensation expense, could make our operating results less predictable and affect the way we compensate our employees or cause other changes in the way we conduct our business.

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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 control over financial reporting is 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. The Company will measure as of June 30, 2006 and re-determine accelerated filer status and applicability of Section 404 requirements.

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 National Market 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.

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 ICSI 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;

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- 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.

Manouch Moshayedi, Mike Moshayedi and Mark Moshayedi, each of whom is an executive officer and director of SimpleTech, are brothers and beneficially own approximately 61.5% of our outstanding common stock at April 30, 2006 (assuming the inclusion of shares of common stock subject to options that are presently exercisable or will become exercisable within 60 days of such date). In addition, they have a non-binding understanding that at any shareholders meeting of SimpleTech where action is to be taken with respect to the election of directors, they each would cause the shares of SimpleTech common stock beneficially owned by them to be voted in favor of their election as directors. As a result, they have the ability to control 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 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 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

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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.

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.

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.

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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 module industry include: Crucial Memory, a division of Micron Technology, Kingston Technology, Lexar Media, M-Systems, PNY Technologies, SanDisk, and SMART Modular. 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.

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 Infineon Technology 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.

The Flash-based storage market is constantly evolving, and we may not have rights to manufacture and sell certain types of products utilizing emerging new Flash formats, or we may be required to pay a royalty to sell products utilizing these formats.

The Flash-based storage market is constantly undergoing rapid technological change and evolving industry standards. Many consumer devices, such as digital cameras, PDAs and smartphones, may transition to emerging Flash memory formats, such as the xD Picture Card format, which we do not currently manufacture and do not have rights to manufacture. This will likely result in a decline in demand, on a relative basis, for other products that we manufacture such as CompactFlash, Secure Digital, Mini-SD and MultiMedia cards. If we decide to manufacture Flash products utilizing emerging formats, we may be required to secure licensing arrangements to give us the right to manufacture such products which may not be available at reasonable rates or at all. If we are not able to supply all Flash card formats at competitive prices or if we were to have product shortages, our revenues could be adversely impacted and our customers would likely cancel orders or seek other suppliers to replace us.

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, Mike Moshayedi, our President, and Mark Moshayedi, our Chief Operating Officer, Chief Technical Officer and Secretary. In addition, as a result of our adoption of SFAS 123(R), 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

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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 12.7% of our revenues in the first quarter of 2006 and 12.5% in the first quarter of 2005. No foreign geographic area or single foreign country accounted for more than 10.0% of our revenues in each of the first quarters of 2006 or 2005. For the first quarters of 2006 and 2005, 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 continue to 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 and otherwise operate our business. There can be no assurance that we will be profitable on a quarterly or annual basis in the future.

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.

Our ability to use our tax credit carryforwards may be substantially limited, which could harm our financial condition.

In recent years, we have generated state tax credits, which we are not fully able to utilize at this time. The availability of some of these state tax credit carryforwards is subject to certain limitations. We had the following state credits as of March 31, 2006: research and development credit carryforwards of approximately $1.9 million, which carryforward indefinitely and enterprise zone credit carryforwards of approximately $1.9 million, which carryforward indefinitely. We periodically review our ability to use our tax credit carryforwards. Based on this periodic review, we may determine that the amount of tax credit carryforwards that can be utilized to offset future tax liabilities should be limited. Since a potential limitation is based on a number of factors, we cannot determine the impact of such a limitation at this time, but if our ability to use tax credit carryforwards were substantially limited, it could harm our financial condition.

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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 labors 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.

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;

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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

(b) Use of Proceeds from Sales of Registered Securities

On October 4, 2000, we completed our initial public offering of our common stock pursuant to our Registration Statement on Form S-1 (File No. 333-32478) that was declared effected by the Securities and Exchange Commission on September 28, 2000. There has been no material change with respect to our use of the net proceeds from our initial public offering to the information discussed in our Annual Report on Form 10-K for the year ended December 31, 2000. We continue to invest the remaining net proceeds in short-term, interest-bearing instruments, pending their use to fund working capital and other general corporate purposes, including expansion of sales and marketing activities, enhancement of our technology, possible acquisitions and international expansion.

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 Number	Description
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

* 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 SimpleTech, 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.

	SIMPLETECH, INC., a California corporation
Date: May 15, 2006	/s/ DAN MOSES Dan Moses Chief Financial Officer (Principal Financial Officer and Duly Authorized Signatory)

SIMPLETECH, INC.

Index to Exhibits

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