DESWELL INDUSTRIES INC
Form 20-F
July 16, 2004

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SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 20-F

[ ] Registration Statement Pursuant to Section 12(b) or (g) of the Securities Exchange Act of 1934

OR

[X] Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the Fiscal Year Ended: March 31, 2004	Commission File Number: 0-26448

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

British Virgin Islands
(Jurisdiction of incorporation or organization)

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

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

Securities registered pursuant to Section 12(g) of the Act:

Common shares, no par value per share

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

As of March 31, 2004, there were 9,149,085 common shares of the registrant outstanding.

Indicate by check mark whether the registrant: (i) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (ii) has been subject to such filing requirements for the past 90 days.

Yes [X] No [ ]

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

Item 17 [ ] Item 18 [X]

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

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

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

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

FINANCIAL STATEMENTS AND CURRENCY PRESENTATION

The Company prepares its consolidated financial statements in accordance with generally accepted accounting principles in the United States of America and publishes such statements in United States dollars. See Independent Auditors Report included elsewhere herein. The Company publishes its financial statements in United States dollars as the Company is incorporated in the British Virgin Islands, where the currency is the United States dollar, and the functional currency of the Company s subsidiaries are Hong Kong dollar and Chinese renminbi. All dollar amounts ($) set forth in this Report are in United States dollars, the references to HK$ refer to Hong Kong dollars and RMB to Chinese renminbi.

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PART I

ITEM 1. IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISORS

Not applicable.

ITEM 2. OFFER STATISTICS AND EXPECTED TIMETABLE

Not applicable.

ITEM 3. KEY INFORMATION

Selected Financial Data (1)

The selected consolidated financial data set forth below should be read in conjunction with our consolidated financial statements and notes thereto included elsewhere in this Report. The selected income statement data for each of the three fiscal years in the period ended March 31, 2004, and the balance sheet data as of March 31, 2003 and 2004 are derived from our audited consolidated financial statements included in this Report. The selected income statement data for the years ended March 31, 2000 and 2001, and the balance sheet data as of March 31, 2000, 2001 and 2002 are derived from our audited consolidated financial statements, which are not included in this Report.

	(In thousands, except per share and percentage data) Year ended March 31,				
	2000	2001	2002	2003	2004
Income Statement Data					
Net sales	$60,958	$80,847	$83,320	$90,905	$97,195
Cost of sales	38,262	52,596	54,448	61,006	66,105
Gross profit	22,696	28,251	28,872	29,899	31,090
Selling, general and administrative expenses	11,970	15,414	14,939	15,354	14,718
Operating income	10,726	12,837	13,933	14,545	16,372
Interest expense	(3)	(6)	(26)	(6)	(16)
Other income, net	898	915	877	818	910
Income before income taxes	11,621	13,746	14,784	15,357	17,266
Income taxes	890	315	535	3,826	589
Income before minority interests	10,731	13,431	14,249	11,531	16,677
Minority interests	433	621	925	1,288	1,957

Net income	$10,298	$12,810	$13,324	$10,243	14,720
Basic earnings per share (2)(3)	$ 1.27	$ 1.59	$ 1.59	$ 1.18	$ 1.62
Average number of shares outstanding basic (2)(3)	8,118	8,064	8,403	8,672	9,109
Diluted earnings per share (3)	$ 1.26	$ 1.57	$ 1.57	$ 1.16	$ 1.56
Average number of shares outstanding diluted (2)(3)	8,174	8,153	8,466	8,852	9,440
Statistical Data:					
Gross margin	37.2%	34.9%	34.7%	32.9%	32.0%
Operating margin	17.6%	15.9%	16.7%	16.0%	16.8%
Dividends per share (3)	$ 0.59	$ 0.59	$ 0.86	$ 0.77	$ 0.94

	At March 31,				
	2000	**2001**	**2002**	**2003**	**2004**
Balance Sheet Data					
Working capital	$44,727	$47,356	$54,922	$ 58,223	$ 52,876
Total assets	71,841	83,466	94,744	106,172	113,534
Long-term debt, less current portion					
Total debt			482		
Shareholders equity	53,031	63,877	69,651	81,846	89,730

(1) Our consolidated financial statements are prepared in accordance with generally accepted accounting principles in the United States of America and are stated in U.S. dollars. See Financial Statements and Currency Presentation.

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

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

Risk Factors

We may from time to time make written or oral forward-looking statements. Written forward-looking statements may appear in this document and other documents filed with the Securities and Exchange Commission, in press releases, in reports to shareholders, on our website, and other documents. The Private Securities Reform Act of 1995 contains a safe harbor for forward-looking statements on which we rely in making such disclosures. In connection with this safe harbor we are hereby identifying important factors that could cause actual results to differ materially from those contained in any forward-looking statements made by us or on our behalf. Any such statement is qualified by reference to the following cautionary statements:

We face numerous risks as a result of our operations in China and Hong Kong.

Our manufacturing facilities are located in China. As a result, our operations and assets are subject to significant political, economic, legal and other uncertainties associated with doing business in China, which are discussed in more detail below.

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

Over the past several years, the Chinese government has pursued economic reform policies including the encouragement of private economic activity and greater economic decentralization. The Chinese government may not continue to pursue these policies or may significantly alter them to our detriment from time to time without notice. Changes in policies by the Chinese government resulting in changes in laws, regulations, or their interpretation, or the imposition of confiscatory taxation, restrictions on currency conversion or imports and sources of supply could materially and adversely affect us. The nationalization or other expropriation of private enterprises by the Chinese government could result in the total loss of our investment in that country.

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

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

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

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

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

Firefighting and disaster relief or assistance in China are primitive by Western standards. At March 31, 2004, we maintained fire, casualty and theft insurance aggregating approximately $39,576,000 covering certain of our stock in trade, goods and merchandise, furniture and equipment and factory buildings in China. The proceeds of this insurance may not be sufficient to cover material damage to, or the loss of, any of our factories due to fire, severe weather, flood, or other act of God or cause. We do not maintain any business interruption insurance.

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

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

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

Under applicable Chinese law, we have been afforded a number of tax concessions by the Chinese taxing authorities and have avoided paying taxes on a substantial portion of our operations in China by reinvesting all or part of the profits attributable to our Chinese plastic manufacturing subsidiary for at least five years. However, the Chinese tax system is subject to substantial uncertainties with respect to its interpretation and enforcement. Currently, under the Chinese tax system we can obtain tax breaks by reinvesting profits of certain of our subsidiaries in China. We reinvested a portion of our profits of $4,000,000, from our Chinese plastic manufacturing subsidiary for the year ended December 31, 2001 and, we are subject to taxes of 7.5% on these operations for the remaining profits for tax year ended December 31, 2001. For the tax years commencing January 1, 2002, 2003 and 2004, the Company is subject to taxes of 10%, 10% and 15% respectively, on these operations and has made a provision for taxes for the 2002, 2003 and 2004 tax years on its financial statements at and for the years ended March 31, 2003 and 2004, respectively. Following the Chinese government s program of privatizing many state owned enterprises, the Chinese government has attempted to augment its revenues through heightened tax collection efforts. Continued efforts by the Chinese government to increase tax revenues could result in decisions or interpretations of the tax laws by the Chinese tax authorities that would increase our future tax liabilities or deny us expected concessions or refunds.

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

Corruption, extortion, bribery, pay-offs, theft, and other fraudulent practices are common in China. We could suffer losses from these practices if we are not successful in implementing and maintaining preventative measures.

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

While China has been granted permanent most favored nation trade status in the United States, controversies between the United States and China may arise that threaten the status quo involving trade between the United States and China. These controversies could adversely affect our business by, among other things, causing our products in the United States to become more expensive, which could result in a reduction in the demand for our products by customers in the United States. Political or trade friction between the United States and China, whether or not actually affecting our business, could also adversely affect the prevailing market price of our common shares.

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Changes in currency rates involving the Hong Kong dollar or Chinese yuan could increase our expenses or cause economic or political problems affecting our business.

Our sales are predominately denominated in Hong Kong dollars. The Chinese government may not continue to maintain the present currency exchange mechanism, which fixes the Hong Kong dollar at approximately 7.80 to each United States dollar. If the currency exchange mechanism between the Hong Kong dollar and the U.S. dollar is changed, our results of operations and financial condition could be materially adversely affected. Any material increase in the value of the Hong Kong dollar or Chinese yuan relative to the U.S. dollar would increase our expenses when translated to US dollars. A devaluation of the Hong Kong dollar or yuan relative to the U.S. dollar would be likely to reduce our expenses when translated to US dollars. However, any benefits we receive from devaluation could be offset if the devaluation results in inflation or political unrest.

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

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

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

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

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

In August 2003, we set up a new administration and accounting office in Macao, formerly a Portuguese Colony and in December 2003 closed our office in Hong Kong, formerly a British Crown Colony. Some of our customers and suppliers remain in Hong Kong. Sovereignty over Hong Kong and Macao were transferred to China effective on July 1, 1997 and December 20, 1999, respectively. Since their transfers, Hong Kong and Macao have become Special Administrative Regions of China, enjoying a high degree of autonomy except for foreign and defense affairs. Moreover, China s political system and policies are not practiced in Hong Kong and Macao. Under the principle of one country, two systems, Hong Kong and Macao maintain legal systems that are different from that of China. Hong Kong s legal system is based on the Basic Law of the Hong Kong Special Administrative Region and, similarly, Macao s legal system is based on the Basic Law of the Macao Special Administrative Region. It is generally acknowledged as an open question whether Hong Kong s future prosperity in its role as a hub and gateway to China after China s recent accession to the World Trade Organization (introducing a market liberalization in China) will be diminished. The continued stability of political, economic or commercial conditions in Hong Kong and Macao remain uncertain, and any instability could have an adverse impact on our business.

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

Historically, a substantial percentage of our sales have been to a small number of customers. Our four largest customers during the year ended March 31, 2004 were Digidesign Inc., VTech Telecommunications Limited, Epson Precision (H.K.) Limited and, Inter-Tel Incorporated. Each of these customers individually accounted for 10% or more of our total net sales during the year ended March 31, 2004 and accounted for an aggregate of 49.1%, 60.4% and 61.1%, respectively, of our total net sales during the years ended March 31, 2002, 2003 and 2004, respectively. Our sales are based on purchase orders and we have no long-term contracts with any of our customers and the percentage of sales to any of our customers may fluctuate from time to time. The loss of any one of our largest customers or a substantial reduction in orders from any of them would adversely impact our sales and decrease our net income or cause us to incur losses unless and until we were able to replace the customer or order with one or more of comparable size. In addition, a substantial portion of our sales is made on credit and our results of operations would be adversely affected if a major customer were unable to pay for our products or services.

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

The primary materials used by us in the manufacture of our plastic injection molded products are various plastic resins. The following table shows our cost of plastic resins as a percentage of our cost of plastic products sold and as a percentage of our total costs of goods sold for the years ended March 31, 2002, 2003 and 2004:

	Year ended March 31,		
	2002	**2003**	**2004**
Resins cost as a % of plastic products sold	52%	53%	52%
Resins cost as a % of total cost of goods sold	25%	25%	25%

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

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

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

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

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

0.6%, from 34.9% during the year ended March 31, 2001 to 34.7% during the year ended March 31, 2002.

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

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

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

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

We are incorporated in the British Virgin Islands and have subsidiaries incorporated in the British Virgin Islands, Hong Kong, Macao, Samoa, Malaysia and China. Our administrative and accounting office is located in Macao. We manufacture all of our products in China. As of March 31, 2004, approximately 61% of the net book value of our total identifiable fixed assets was located in China. We sell our products to customers principally in China, the United States, Europe and Hong Kong. Our international operations may be subject to significant political and economic risks and legal uncertainties, including:

- changes in economic and political conditions and in governmental policies,
- changes in international and domestic customs regulations,
- wars, civil unrest, acts of terrorism and other conflicts,
- changes in tariffs, trade restrictions, trade agreements and taxation,
- difficulties in managing or overseeing foreign operations, and
- limitations on the repatriation of funds because of foreign exchange controls.

The occurrence or consequences of any of these factors may restrict our ability to operate in the affected region and decrease the profitability of our operations in that region.

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

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

- Richard Lau, our Chairman of the Board and Chief Executive Officer;
- C. P. Li, our Executive Director, General Manager in charge of our day-to-day manufacturing and administrative operations for plastic products, and Chief Financial Officer;

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

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

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

Dickson Lam, our Director of Marketing for plastic and electronic products.

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

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

Our senior management as a group, each of whom are also members and constitute a majority of our board of directors, directly or indirectly through an affiliated company beneficially own approximately 37.4% our shares at June 30, 2004. As a result, acting together they may be able to control, and they can substantially influence, the outcome of all matters requiring approval by our shareholders, including the election of directors and approval of significant corporate transactions. This ability may have the effect of delaying or preventing a change in control of Deswell, or causing a change in control of Deswell that may not be favored by our other shareholders.

Our board s ability to amend our charter without shareholder approval could have anti-takeover effects that could prevent a change in control.

As permitted by the law of the British Virgin Islands, our Memorandum and Articles of Association, which are the terms used in the British Virgin Islands for a corporation s charter and bylaws, may be amended by our board of directors without shareholder approval provided that a majority of our independent directors do not vote against the amendment. This includes amendments to increase or reduce our authorized capital stock. Our board s ability to amend our charter documents without shareholder approval could have the effect of delaying, deterring or preventing a change in control of Deswell, including a tender offer to purchase our common shares at a premium over the then current market price.

Our exemptions from certain of the reporting requirements under the Exchange Act limits the protections and information afforded to investors.

We are a foreign private issuer within the meaning of rules promulgated under the Securities Exchange Act of 1934. As a foreign private issuer, we are exempt from certain provisions applicable to United States public companies including:

- the rules under the Exchange Act requiring the filing with the Commission of quarterly reports on Form 10-Q or current reports on Form 8-K;

- the sections of the Exchange Act regulating the solicitation of proxies, consents or authorizations in respect to a security registered under the Exchange Act;

- and the sections of the Exchange Act requiring insiders to file public reports of their stock ownership and trading activities and establishing insider liability for profits realized from any short-swing trading transaction (i.e., a purchase and sale, or sale and purchase, of the issuer s equity securities within less than six months).

In addition, because the Company is a foreign private issuer, certain of the corporate governance standards of The Nasdaq Stock Market that are applied to domestic companies having securities included on The Nasdaq Stock Market may not be applied to us or their effectiveness may be delayed beyond the effective date applicable to domestic companies.

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

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ITEM 4. INFORMATION ON THE COMPANY

History and Development of Deswell

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

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

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

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

The Company s incorporation in the British Virgin Islands in December 1993 was part of a restructuring in which Deswell Industries, Inc. was organized to become the ultimate parent holding company of the companies engaged in actual business operations and to spin off to Messrs. Lau, Li and Leung other companies that hold real estate in Hong Kong. This restructuring, which was completed in March 1994 involved the following steps. First,

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on December 13, 1993, the Company (i) allotted a total of 2,539 common shares to provide the initial capital of the Company and (ii) acquired the entire issued share capital of Leesha Holdings Limited, the former ultimate parent company, in exchange for which it issued a total of 3,387,304 common shares. These shares were issued in equal portions to Messrs. Lau, Li and Leung, the former shareholders of Leesha Holdings Limited. Second, on March 22, 1994, the Company acquired the entire issued share capitals of Jetcrown, Marcon (including its interest in Jetcrown Shenzhen) and Richtex from Leesha Enterprises Limited, a wholly owned subsidiary of Leesha Holdings Limited and a second-tier holding company, in exchange for which the Company issued an aggregate of 7,618 common shares in equal proportions to Messrs. Lau, Li and Leung. Third, also on March 22, 1994, the Company acquired Leesha Enterprises Limited s 50.00005% interest in Kwanasia in exchange for the issue of 2,539 common shares in the Company in equal proportions to Messrs. Lau, Li and Leung and the assignment of a debt due to Jetcrown of approximately $465,000 relating to the original purchase of Kwanasia. Finally, on March 22, 1994, the Company made a distribution in specie of the entire share capital of Leesha Holdings Limited to Messrs. Lau, Li and Leung. The immediate effect of this restructuring was that the Company wholly owned Jetcrown, Marcon (which wholly owned Jetcrown Shenzhen) and Richtex and also owned 51% of the outstanding capital stock of Kwanasia (which, in turn had a 100% economic interest in Shenzhen Kwanam). Messrs. Lee and Tam owned the balance of Kwanasia. In 1995, this restructuring was fine-tuned for tax purposes, with the Company forming two new corporations, Union International Limited (which changed its name to Integrated International Limited on May 1, 1996) (Integrated) and Oriental Enterprises Limited (which changed its name to Bright Oriental Enterprises Limited on May 1, 1996) (Oriental Enterprises), both corporations organized under the laws of Western Samoa. Integrated issued its shares proportionately to Deswell and Messrs. Lee and Tam in exchange for all outstanding capital stock of Kwanasia respectively held by them, with the result that through February 1998, Integrated was 51%-owned by Deswell and 49%-owned by Messrs. Lee and Tam. In March 1998, Messrs. Lee and Tam together sold 5% shareholding interest in Integrated to another minority shareholder. In January 2003, the Company increased its interest in Integrated to 71% by purchasing an additional 20% from Messrs. Lee and Tam in exchange for the issuance to Messrs. Lee and Tam of an aggregate of 251,880 common shares of Deswell. Integrated in turn owns all of the outstanding capital stock of Kwanasia. Messrs. Lee and Tam still own, in equal shares, 24% of the capital stock of Integrated and continue to serve as the executives in charge of administrative and manufacturing operations, respectively, for the Company s contract manufacturing operations for electronic products and subassemblies. See Item 6 Directors, Senior Management and Employees.

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

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

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

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

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

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

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

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

In October 2003, the Company organized Ideatop Holdings Limited (Ideatop), a British Virgin Islands International Business Company to hold the beneficial ownership of Jetcrown Industrial (Shenzhen) Limited. The registration with the Chinese Government was approved in December 2003.

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

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

For a chart showing the Company s organizational structure at March 31, 2004 (which excludes companies that were dormant at, or sold prior to, that date), see Organizational Structure, below.

Capital Expenditures

Principal capital expenditures and divestitures made by Deswell during the three years in the period ended March 31, 2004 include the following:

	2002	2003	2004
Purchase of property, plant and equipment	$4,397,000	$9,731,000	$19,862,000
Proceeds from the sale of property, plant and equipment	276,000	127,000	430,000

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

Through March 31, 2004, Deswell spent an aggregate of approximately $12 million on the first phase of construction of its new plastic injection molding plant. The facility comprises approximately 440,000 square feet of factory space, an 85,000 square foot amenity center and 95,000 square feet of dormitory space. Construction began in October 2001 and was completed in March 2003 with interior build-out finished in June 2003. After installation of machinery and final touch up, Phase I of the new factory became operational at the end of November 2003. During the same period, approximately $12 million was used to expand the Company s injection molding and tool-making capacity through the purchase of additional injection molding and tooling machinery.

Following completion of space built through Phase I, we estimate spending an aggregate of approximately $6 million for the second phase of construction, which will comprise an additional two factory building units covering approximately 220,000 square feet and three additional dormitory units of approximately 195,000 square feet. Phase III of construction, with a planned investment of $10 million, will consist of an approximate 110,000 square foot office building, an additional 370,000 square feet of factory space and one additional dormitory unit of 95,000 square feet. Phase IV of construction, which will consist of an additional two dormitory units and two other buildings, is planned for the long-term, with construction to begin following completion of Phase III, as resources become available.

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

All of the foregoing capital expenditures were financed principally from internally generated funds and our current plan is to continue to use internally generated funds principally to finance future capital expenditures.

Business Overview

Introduction to Deswell

The Company is an independent manufacturer of injection-molded plastic parts and components, electronic products and subassemblies and metallic molds and accessory parts for original equipment manufacturers, or OEMs and contract manufacturers. The Company conducts all of its manufacturing activities at separate plastics, electronics and metallic operation factories located in the People s Republic of China.

The Company produces a wide variety of plastic parts and components that are used in the manufacture of consumer and industrial products, using different plastic injection technologies, such as film injection, integrated injection and insert injection. The products include

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

- double injection caps and baby products;
- laser key caps; and
- automobile components.

Electronic products manufactured by the Company include

- complex printed circuit board assemblies using surface mount (SMT), ball grip assembly (BGA) and pin-through-hole (PTH) interconnection technologies and
- finished products which include
  - Ø telecommunication products such as special purpose telephones used as a private automated branch exchange (IPBX), a network terminal and an internet platform etc.,
  - Ø IP switches, routers, and

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- Ø sophisticated professional audio equipment such as power amplifiers, digital mixers, digital signal processors, etc.

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

As part of its manufacturing operations, the Company consults with its customers in the design of plastic parts and the design and production of the molds used to manufacture plastic parts, which are made by Deswell at its customers expense, and provides advice and assistance in the design and manufacturing of printed circuit boards. The Company believes that its ability to manufacture high-end plastic and metal parts of the quality required by OEMs and contract manufacturers which furnish products and services internationally, Deswell s expertise in designing and manufacturing molds for its customers and the Company s low production costs distinguish Deswell from most other manufacturers of plastic products and provide it with a competitive advantage. However, as a result of increased competition, Deswell has been forced to reduce the sales prices of its products during the years ended March 31, 2002, 2003 and 2004, which has resulted in lower gross profit margins during these years.

Industry Overview

Management believes that the injection molding and metal molds and parts manufacturing industries have each benefited in recent years from a trend among major users of injection molded and metal products to outsource an increasing portion of the parts requirements and to select a small number of suppliers or a sole supplier to provide those products. The Company is not aware of any empirical data defining the manufacturing industry in China, however, management believes that injection molding and metal manufacturing firms which are much smaller than the Company make up the largest segment of the industry in China. The Company s experience indicates that such smaller firms are often unable to react quickly and responsively to the diverse demands of many customers and are not capable of furnishing the level of quality that high-end plastic and metal products require. Management believes that this inability on the part of these smaller manufacturers has created opportunities for the Company to increase sales by catering to the outsourcing requirements of OEMs and contract manufacturers that manufacture such high-end products.

Similarly, as a result of the recognition by OEMs in the electronics industry of the rising costs of operating a manufacturing site and the need to add more sophisticated and expensive manufacturing processes and equipment, OEMs have turned increasingly to outside contract manufacturers. By doing so, OEMs are able to focus on research, product conception, design and development, marketing and distribution, and to rely on the production expertise of contract manufacturers. Other benefits to OEMs of using contract manufacturing include: access to manufacturers in regions with low labor and overhead costs, reduced time to market, reduced capital investment, improved inventory management, improved purchasing power and improved product quality. In addition, the use of contract manufacturers has helped OEMs manage production in view of increasingly shorter product life cycles.

Operations

Plastic Injection Molding

Plastic injection molding manufacturing accounted for 57.0%, 54.9% and 54.6% of the Company s total sales during the years ended March 31, 2002, 2003 and 2004, respectively. At March 31, 2004, the Company conducted its plastic manufacturing operations in approximately 401,000 and 520,000 square feet of factory space in its factories located in Shekou, Shenzhen, China and Dongguan, Guangzhou, China, respectively.

The Company s plastic injection molding process consists of three phases: (1) mold design and production; (2) plastic injection; and (3) finishing.

Mold design and production. The plastic injection-molding process begins when a customer provides the Company with specifications for a product or part, which specifications are often created in consultation with the Company s technical staff. Next the Company designs and produces the mold, using great care in the design process and in the selection of materials to produce the mold in an effort to create a high quality appearance of the completed product by reducing or eliminating potential flaws such as the sinkage of materials and irregularities in the knit line of joints.

The mold-making process ranges from 25 to 75 days, depending on the size and complexity of the mold. Mold making requires specialized machines and is capital intensive. At March 31, 2004, the Company used 26 EDMs (electrical discharge machines), 25 CNC (computer numerical control) milling machines and 78 NC (numerical control) milling machines in the mold-making process.

Deswell is continually adding equipment to expand its mold making and injection molding capabilities. During February to April 2002, the Company purchased 12 additional injection-molding machines with clamping force of 365 to 550 tons for approximately $1.5 million. These new injection-molding machines were installed in July 2002. In December 2002, the Company purchased five additional sets of injection-molding machines with clamping force of 368 to 650 tons for approximately $1 million. These new injection-molding machines, two of which have gas injection functionality, were installed in March 2003. In March 2003, the Company purchased four sets of precision double injection molding machines and one additional injection-molding machine with clamping force of 650 tons for an aggregate of approximately $1 million. These new injection-molding machines were installed in March and July 2003. During the year ended March 31, 2004, the Company purchased approximately $3.6 million worth of small- to medium-size machines and equipment, including 102 sets of Chen Hsong hydraulic injection machines with a clamping force of 55 tons to 218 tons; five sets of double-injection machines with a clamping force of 200 tons; nine sets of Fanuc electric precision-injection machines with a clamping force of 75 tons to 140 tons; four sets of Sumitomo high-speed precision-injection machines with a clamping force of 75 tons to 100 tons; two sets of high-precision large Makino electric discharge machines; and two sets of high-precision Mitsubishi wire-cut machines. Molds produced by the Company generally weigh from 220 to 12,000 pounds and generally cost between $3,000 and $500,000.

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

During the year ended March 31, 2004, the Company made on average about 70 to 100 different molds every month. Management believes that the Company s skills and expertise in mold-making, coupled with having its facilities and operations in China, allow the Company to produce molds at costs substantially less than molds of comparable quality made in Japan, Korea and Taiwan.

Plastic Injection. During the mold-making process, suitable plastic resin for the particular product is selected and purchased. See Raw Materials, Component Parts and Suppliers. The completed mold is mounted onto injection machines, which are classified according to the clamping force (the pressure per square inch required to hold a mold in place during the injection molding process). At March 31, 2004, the Company had 356 injection molding machines, ranging from 50 to 1,600 tons of clamping force, with most machines in the range of from 80 to 100 tons. Each of the Company s machines is capable of servicing a variety of applications and product configurations and the Company has machines, which permit the Company to fabricate plastic parts as small as a button and as large as a 3 ft. x 2 ft. case for a copy machine.

Using separate shifts, injection molding is generally conducted 24 hours a day, seven days per week, other than normal down time for maintenance and changing of product molds. Molding of products requiring extra concerns for appearance, such as cases for calculators, personal organizers and telephones are conducted in an isolated and dust free section of the factory. In a continuous effort to assure quality, the Company s quality control personnel inspect the products produced from each machine generally at hourly intervals during production. When defects are discovered, the Company s maintenance personnel inspect the mold and the machine to determine which is responsible. If the mold is the cause of the defect, it will be immediately removed from the machine and serviced or repaired by one of a team of technicians employed to maintain molds. The mold will then be remounted on the machine and production will continue. If the machine is the source of the defect, the Company s technicians and engineers service the machine immediately. Through this continuous vigilance to molds and machines, the Company has experienced what it believes to be a relatively low scrap rate and has been able to maintain a high level of productivity of its injection molding machines.

Finishing. After injection molding, products are finished. Finishing consists of smoothing and polishing, imprinting letters, numbers and signs through silk screening process, pad printing or epoxy ultra violet cutting, and treating the product with an anti-fog coating for a lasting and attractive appearance. Most of these functions are conducted by hand.

Electronic Products and Assemblies

In an aggregate of approximately 216,000 square feet of factory space at March 31, 2004 located at facilities in Dongguan, China, the Company manufactures and assembles electronic products and electronic assemblies for OEMs. Finished products include consumer and sophisticated studio-quality audio equipment, IPBX and commercial telephone units, network education platforms, IP switches, routers etc. Assemblies consist of PCBs with passive (e.g., resistors, capacitors, transformers, switches and wire) and active (e.g., semiconductors and memory chips) components mounted on them. During the years ended March 31, 2002, 2003 and 2004, manufacturing of electronic products accounted for approximately 40.4%, 42.0% and 41.2%, respectively, of the Company s total sales. During the same periods, manufacturing of finished products accounted for 96%, 97% and 99%, respectively, of electronic product sales and assembling of printed circuit boards accounted for the balance of such sales during those periods.

In assembling printed circuit boards the Company purchases printed circuit boards, surface mounted components and chips and uses PTH, BGA and SMT interconnection technologies to assemble the other components onto the PCBs. Completed PCBs are checked by in-circuit-testers before delivery.

PTH is a method of assembling printed circuit boards in which component leads are inserted and soldered into plated holes in the board. While this technology is several decades old and is labor intensive, it still has a significant market, particularly for consumer product applications.

BGA is a method of mounting an integrated circuit or other component to a PCB. Rather than using pins that consume a large area of the PCB, the component is attached to the circuit board with small balls of solder at each contact. This method allows for greater component density and is used in more complex PCBs.

SMT is the method of assembling printed circuit boards in which components are fixed directly to the surface of the board, rather than being inserted into holes. With this process, solder is accurately stenciled in paste form on pads located on the printed circuit board, the components are then placed onto the solder paste and heated to the point of melting the paste (a process called reflow) to establish a strong solder joint. The SMT process allows for more miniaturization, cost savings and shorter lead paths between components (which results in faster signal speed and improved reliability). Additionally, it allows components to be placed on both sides of the printed circuit board, a major factor in the miniaturization process.

Manufacturing operations include PCB assembly and testing and, in those cases where finished products are to be provided, assembly into final product housing. While the Company has automated various aspects of the many processes, the assembly of components into electronic products remains a labor-intensive process generally requiring a high degree of precision and dexterity in the assembly stage and multiple quality control checks prior to shipment. The Company utilizes specially designed equipment and techniques to maintain its ability to assemble efficiently a wide variety of electronic products and assemblies.

Metal Parts Manufacturing

In an aggregate of approximately 117,000 square feet of factory space at March 31, 2004 located at facilities in Dongguan, China next to the Company s electronic products assembly facilities, Deswell s metal forming division manufactures metallic molds and accessory parts for use in audio equipment, routers, payphones, multimedia stations and ATMs. The Company s metal molds and metal parts (products) manufacturing accounted for approximately 2.6%, 3.1% and 4.2% of Deswell s total sales during the years ended March 31, 2002, 2003 and 2004, respectively.

Quality Control

The Company maintains strict quality control procedures for its products. At hourly intervals, the Company s quality control personnel monitor machines and molds to assure that plastic parts are free from defects.

For electronic operations, the Company s quality control personnel check all incoming components. Moreover, during the production stage, the Company s quality control personnel check all work in process at several points in the production process. Finally, after the assembly stage, the Company randomly checks finished products.

Plastic, electronic and metal products manufactured and assembled at the Company s facilities have a low level of product defects, and aggregate returns represented less than 3% of total net sales during each of the years ended March 31, 2002, 2003 and 2004.

In 1995, the Company earned ISO 9002 certifications for both its plastic and electronic products manufacturing operations. In April 2000, the Company also received ISO 9002 for its metal manufacturing operation. The ISO or International Organization for Standardization is a Geneva-based organization dedicated to the development of worldwide standards for quality management guidelines and quality assurance. ISO 9000, which is the first quality system standard to gain worldwide recognition, requires a company to gather, analyze, document and monitor and to make improvements where needed. ISO 9002 is the ISO level appropriate for manufacturers like the Company. The Company s receipt of ISO 9002 certification demonstrates that the Company s manufacturing operations meet the established world standards.

In August 2003, the Company s plastic injection manufacturing plant in Shenzhen obtained ISO 14001 certification, which evidences that the Company s environmental management standards or EMS meet established international standards. ISO 14000 is a series of international standards on environmental management, ISO 14001 is the most well known of these standards and is often seen as the corner stone standard of the ISO 14000 series.

The Company is working toward having its plastic injection manufacturing plant obtain QS-9000 qualifications. QS-9000 is an internationally recognized set of quality system requirements for the automotive industry, in which industry leaders such as Chrysler, Ford and General Motors set out their fundamental quality system expectations for internal and external suppliers of production and service parts and materials. The Company is on course to achieve QS-9000 certification by mid-2005.

Raw Materials, Component Parts and Suppliers

Plastic Resins. The primary raw materials used by the Company in the manufacture of its plastic parts are various plastic resins, primarily ABS (acrylonitrile-butadiene-styrene), which in the years ended March 31, 2002, 2003 and 2004 averaged approximately 52%, 53% and 52%, respectively, of the Company s cost of plastic products sold and 25%, 25% and 25%, respectively, of the Company s total cost of goods sold. Because plastic resins are commodity products, the Company selects its suppliers primarily based on price. The Company has no long-term supply agreements for plastic resins. The Company currently obtains its plastic resins from suppliers in Hong Kong, Japan and Taiwan and normally maintains a three to four month inventory supply.

The Company used in excess of 14,720,000 pounds of plastic resins during the year ended March 31, 2004 Management believes that the Company s large volume purchases of plastic resin have generally resulted in lower unit raw material costs and generally has enabled the Company to obtain adequate shipments of raw materials. While the Company is not generally bound by fixed price contracts with its customers, the Company has found that increases in resin prices can be difficult to pass on to its customers and, as a consequence, a significant increase in resin prices could have, and in the past has had, a material adverse effect on the Company s operations.

The primary plastic resins used by the Company are produced from petrochemical intermediates derived from products of the natural gas and crude oil refining processes. Natural gas and crude oil markets have in the past experienced substantially cyclical price fluctuations as well as other market disturbances including shortages of supply and crises in the oil producing regions of the world. The capacity, supply and demand for plastic resins and the petrochemical intermediates from which they are produced are also subject to cyclical and other market factors.

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Consequently, plastic resin prices may fluctuate as a result of natural gas and crude oil prices and the capacity, supply and demand for resin and petrochemical intermediates from which they are produced.

Although the plastics industry has from time to time experienced shortages of plastic resins, the Company has not experienced to date any such shortages. Management believes that there are adequate sources available to meet the Company s raw material needs.

Component Parts and Supplies. The Company purchases over 500 different component parts from more than 100 suppliers and is not dependent upon any single supplier for any essential component. The Company purchases from suppliers in Japan, Taiwan, Korea, Hong Kong and elsewhere. At various times there have been shortages of parts in the electronics industry, and certain components, including PCBs and semiconductors, have been subject to limited allocations. Although shortages of parts and allocations have not had a material adverse effect on the Company s results of operations, there can be no assurance that any future shortages or allocations would not have such an effect.

Raw Metal. The primary materials used by the Company in metal molds and parts manufacturing are various metals, but purchases of raw metal were immaterial to the Company s total operations during the years ended March 31, 2002, 2003 and 2004. Typically the Company buys metals from a variety of suppliers in Hong Kong and China and has no long-term contracts with metal suppliers.

Transportation

Transportation of components and finished products to customers in Shenzhen and to and from Hong Kong and Shenzhen and Dongguan is by truck. Generally, the Company sells its products F.O.B. China or F.O.B. Hong Kong. To date, the Company has not been materially affected by any transportation problems and has found that the transition of Hong Kong to Chinese control in July 1997 has not had an adverse impact on the Company s ability to transport goods to and from Hong Kong and China.

Customers and Marketing

The Company s customers are OEMs and contract manufacturers. The Company sells its products in Asia (Hong Kong, Japan and China), the United States and Europe (Germany, United Kingdom, France and Italy). Net sales to customers by geographic area are determined by reference to shipping destinations as directed by the Company s customers. For example, if the products are delivered to the customer in Hong Kong, the sales are recorded as generated in Hong Kong; if the customer directs the Company to ship its products to Europe, the sales are recorded as sold to Europe. See Note 16 of Notes to Consolidated Financial Statements for the dollar amounts of export sales by geographic area for each of the years ended March 31, 2002, 2003 and 2004. Net sales as a percentage of total sales to customers by geographic area consisted of the following for the years ended March 31, 2002, 2003 and 2004:

Geographic areas	2002	2003	2004
China	56.3%	58.9%	51.6%
United States	23.2	28.5	38.4
Europe	4.9	8.2	5.9
Hong Kong	14.0	3.1	2.3
Others	1.6	1.3	1.8
Total	100.0%	100.0%	100.0%

The Company markets its products and services to existing customers through direct contact with the Company s management and direct sales personnel. The Company s sales personnel attend trade shows advertise in trade publications such as *Modern Plastics International* and *Injection Molding*. Collecting information from trade-show, as well as websites, Deswell s marketing staffs contacts existing and potential customers directly by telephone, mail, fax, e-mail via the Internet and in person, stressing Deswell s capability as a complete solution provider for plastic injection mold design, tooling and molding as well as an electronics manufacturing services, or EMS, provider of advanced technology manufacturing processes and flexible logistic services.

Major Customers

The table below sets forth each of the Company s customers which accounted for 10% or more of net sales during the year ended March 31, 2004 the products purchased and the percentage of total Company net sales accounted for by such customers during the years ended March 31, 2002, 2003 and 2004.

		Year ended March 31,		
Customer	**Product**	**2002**	**2003**	**2004**
Digidesign, Inc.	Professional audio equipments	*	13.5%	17.8%
VTech Telecommunications Limited	Telephones and organizers	15.3%	11.6%	17.6%
Epson Precision (H.K.) Limited	Plastic components	17.5%	22.3%	15.4%
Inter-Tel Incorporated	Telephones	11.6%	13.0%	10.3%

* Less than 10%.

The Company s success will depend to a significant extent on the success achieved by its customers in developing and marketing their products, some of which may be new. Many of the industry segments served by the Company s customers are subject to technological change, which can result in short product life cycles. The Company could be materially adversely affected if advances in technology or other factors reduce the marketability of essential products of its customers or if new products being developed by its customers do not attain desired levels of acceptance. If the Company was to lose any customers who account for a material portion of total net sales, or if any of these customers were to decrease substantially their purchases from the Company, the Company s revenues, earnings and financial position would be materially and adversely affected. The Company s dependence on these customers is expected to continue in the foreseeable future.

The Company s sales transactions with all of its customers are based on purchase orders received by the Company from time to time. Except for these purchase orders, the Company has no written agreements with its customers. Sales of plastic parts and metallic products are primarily made on credit terms, with payment in Hong Kong dollars expected within 30 to 60 days of shipment. Sales of electronic products are typically based on letters of credit and are payable in United States dollars. To date the Company has not experienced any significant difficulty in collecting accounts receivable on credit sales. Management communicates regularly with credit sale customers and closely monitors the status of payment and in this way believes it has kept the default rate low. Additionally, plastic parts deliveries are made in several installments over a lengthy period of time, which permits the Company to withhold delivery in the event of any delinquency in payment for past shipments. While the Company has not experienced any difficulty in being paid by its major customers, there can be no assurance that the Company s favorable collection experience will continue in every case or at all. The Company could be adversely affected if a major customer were unable to pay for the Company s products or services.

Competition

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

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

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Patents, Licenses and Trademarks

The Company has no patents, trademarks, licenses, franchises, concessions or royalty agreements that are material to its business.

Seasonality

For information concerning the seasonality of the Company s business, see Seasonality included under Item 5 Operating and Financial Review and Prospects.

Organizational Structure

The chart below illustrates the organizational structure of the Company and its active subsidiaries at March 31, 2004.

Property, Plants and Equipment

Macao

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

Hong Kong

The Company disposed the previously owned Unit 516-517, Hong Leong Industrial Complex, No. 4 Wang Kwong Road, Kowloon Bay, Kowloon, Hong Kong to an unaffiliated party in December 2003. The premises were previously used for accounting and logistic support of its plastic injection molding operations in China.

The Company owns Unit 10-14, 19/F., Kwong Sang Hong Centre, 151-153 Hoi Bun Road, Kwun Tong, Hong Kong. This property has been vacant since July 2002 and is leased to an unaffiliated party for a term of three years to October 2006. The Company leases from an unaffiliated party Unit 605, Hong Leong Industrial Complex, No. 4 Wang Kwong Road, Kowloon Bay, Kowloon, Hong Kong for use as a support office for its electronic and metal operations. The lease expires in July 2004.

Southern China

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

At March 31, 2004 the Company leased approximately 288,000 square feet of manufacturing space at Block A, 1/F-2/F, Block B, 1/F-3/F, Block D, 1/F-5/F, Block F, 1/F-5/F, and Block H, G/F and 2/F-5/F Wing Village Industrial Estate, Shekou, Shenzhen, China which are used for its plastic injection molding operations. These factory premises are leased from the local Chinese government and third parties under separate leases expiring from April 2004 to December 2007. The aggregate monthly rent is approximately $63,100.

In January 2000, the Company acquired under sale and purchase agreement with the local government party an aggregate of approximately 1.3 million square feet of land to construct its own manufacturing plant and dormitory buildings. As at March 31, 2004, there were 440,000 square feet of factory space, 85,000 square feet of amenity space and 95,000 square feet of dormitory built and operational. At March 31, 2004, the Company also leased approximately 58,100 square feet of manufacturing space and 22,400 square feet of ancillary dormitory space at Huangguan Industrial Estate, Houjie Town, Dongguan, Shenzhen, China, which are used for its plastic injection molding operations. The premises are leased from a third party expiring in July 2004. The aggregate monthly rental is approximately $8,100.

The Company leases space at various locations near its plastics manufacturing factories in Shekou and Dongguan that it uses as dormitories for factory workers. Management estimates that the space leased for dormitories approximated 76,900 square feet and 27,100 square feet at March 31, 2004 in Shekou and Dongguan, respectively. The facilities are leased for period of one year, expiring from May 2004 to December 2004. The aggregate monthly rental is approximately $15,900. The Company has acquired under purchase and sale agreements with third parties an aggregate of approximately 24,600 square feet of additional space at various locations near its plastics manufacturing operations in Shenzhen, which are also used as dormitories for factory workers.

In July 2003, the Company completed the acquisition with a third party an aggregate of approximately 244,000 square feet of land and approximately 420,000 square feet of buildings, including six blocks of dormitory buildings, a canteen, a factory building, a car park and a guard room, at Cheung On, Dongguan, China, which was previously named Kwan Hong Building. This property was previously leased by the Company for the use in its contract electronic and metal manufacturing operations. The land use period is for 50 years from February 1, 2003 to January 31, 2053. The Company paid approximately $4,186,000 to acquire this property.

At March 31, 2004, the Company leased approximately 69,400 square feet of manufacturing space in Kwanta Building, Cheung On, Dongguan, China for its contract metal manufacturing operation. These premises are leased from third party expiring in May 2007. The aggregate monthly rental is approximately $7,800.

In addition, the Company leases approximately 28,200 square feet of space at various locations near its contract electronics and metal manufacturing factories in Dongguan, Shenzhen, which are used as staff quarters. The facilities are leased from third parties for periods of one to two years and expire from July 2004 to December 2005. The aggregate monthly rental is approximately $5,100.

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

The Company believes that its existing offices and manufacturing space, together with manufacturing space in close proximity to its existing facilities which management believes will be available as needed for limited expansion, will be adequate for the operation of its business for at least the next two years.

ITEM 5. OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Except for statements of historical facts, this section contains forward-looking statements involving risks and uncertainties. You can identify these statements by forward looking words including expect , anticipate , believe seek estimate . Forward looking statements are not guarantees of Deswell s future performance or results and the Company s actual results could differ materially from those anticipated in these forward-looking statements as a result of certain factors, including those set forth under the section of this Report entitled Item 3. Key Information Risk Factors . This section should be read in conjunction with the Company s Consolidated Financial Statements included under Item 18 of this Report.

Operating Results

The following discussion should be read in conjunction with the consolidated financial statements and notes thereto included later in this Report. The Company prepares its financial statements in accordance with U.S. GAAP.

General

The Company s revenues are derived from the manufacture and sale of injection-molded plastic parts and components, electrical products and subassemblies and metallic molds and accessories. Jetcrown (a wholly owned subsidiary) carries on the plastics operations whereas Integrated carries out the electronics operations. The Company acquired a controlling interest in Integrated s predecessor in October 1992 and has included the results of the predecessor in its consolidated financial statements from the date of acquisition. Integrated acquired a 64.9% interest in Kwanta in October 1996 and the Company has included the results of Kwanta in its consolidated financial statements since the date of acquisition. In April and July 1999, Integrated acquired the remaining 35.1% interest in Kwanta. Through December 2002, the Company owned a 51% interest in Integrated. In January 2003, the Company increased its interest in Integrated to 71% by purchasing an additional 20% from its minority shareholders in exchange for the issuance to them of an aggregate of 251,880 common shares.

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

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The Company s earnings have benefited from favorable overall effective income tax rates of 3.6%, 24.9% and 3.4 % for the years ended March 31, 2002, 2003 and 2004, respectively. The Company is subject to Hong Kong income tax on its income arising in, or derived from, Hong Kong. For information relating to the Company s settlement of a tax dispute with the Hong Kong Inland Revenue Department, or IRD, in 2003 regarding whether Deswell should be assessed additional taxes on profits derived from activities of certain of its subsidiaries during the six fiscal years ended March 31, 2002, see the discussion under Year ended March 31, 2003 Compared to Year Ended March 31, 2002, below. For information regarding Chinese governmental economic, fiscal, monetary or political policies or factors have affected or could materially affect Deswell s operations and investments, please see Item 3. Key Information Risk Factors We Face Numerous Risks as a Result of Our Operations in China And Hong Kong.

Currently, under the Chinese tax system Deswell can obtain tax breaks by reinvesting profits of certain of our subsidiaries in China. Deswell reinvested a portion of our profits of $4,000,000, from its Chinese plastic manufacturing subsidiary for the year ended December 31, 2001 and was subject to taxes of 7.5% on these operations for the remaining profits for tax year ended December 31, 2001. For the tax years commencing January 1, 2002, 2003 and 2004, the Company is subject to taxes of 10%, 10% and 15% respectively, on these operations and has made provision for taxes for the 2002, 2003 and 2004 tax years on its financial statements at and for the years ended March 31, 2003 and 2004.

Certain of the Company s income accrue in tax-free jurisdictions and are not subject to any income taxes. See Note 8 of Notes to consolidated financial statements for a further description of income taxes. The Company expects to continue to benefit from a low overall effective income tax rate in the future, barring unforeseen changes in tax laws and regulations in the various jurisdictions in which it operates. See Uncertain applications of Chinese tax laws could subject us to greater taxes in China included under We face numerous risks as a result of our operations in China and Hong Kong in Item 3. Key Information Risk Factors.

Deswell s material operations are generally organized in three segments: plastic injection molding, or the plastic segment, electronic products assembling and metallic parts manufacturing. Results from Company s metallic parts manufacturing operations have not been material to the Company s operations as a whole and have therefore been combined as the electronic & metallic segment for the table presentation and discussion below. The Company s reportable segments are strategic business units that offer different products and services. The following table sets forth present selected consolidated financial information stated as a percentages of net sales for each of the three years in the period ended March 31, 2004.

	Year ended March 31, 2002			**Year ended March 31, 2003**			**Year ended March 31, 2004**		
	Plastic Injection-Molding Segment	**Electronic & Metallic Segment**	**Total**	**Plastic Injection-Molding Segment**	**Electronic & Metallic Segment**	**Total**	**Plastic Injection-Molding Segment**	**Electronic & Metallic Segment**	**Total**
Net sales	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Cost of sales	55.2	78.8	65.3	57.0	79.4	67.1	60.4	77.2	68.0
Gross profit	44.8	21.2	34.7	43.0	20.6	32.9	39.6	22.8	32.0
Selling, general and administrative	18.8	16.8	18.0	19.1	14.1	16.9	18.5	11.1	15.2

expenses									
Operating income	26.0	4.4	16.7	23.9	6.5	16.0	21.1	11.7	16.8
Interest expense		(0.1)							
Other income, net	1.4	0.7	1.1	1.6		0.9	1.0	0.9	0.9
Income before income taxes and minority interst	27.4	5.0	17.7	25.5	6.5	16.9	22.1	12.6	17.8
Income taxes	0.9	0.3	0.6	4.1	4.3	4.2	0.5	0.8	0.6
Income before minority interests	26.5	4.7	17.1	21.4	2.2	12.7	21.6	11.8	17.2
Minority interests	0.2	2.3	1.1	0.8	2.1	1.4	0.9	3.4	2.0
Net income	26.3%	2.4%	16.0%	20.6%	0.1%	11.3%	20.7%	8.4%	15.1%

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

Net Sales - The Company s net sales for the year ended March 31, 2004, were $97,195,000, an increase of $6,290,000 or 6.9% as compared to year ended March 31, 2003. Sales to Digidesign Inc., Vtech Telecommunications Ltd. (VTech), Epson Precision (H.K.) Ltd. (Epson), and Inter-Tel Incorporated (Inter-Tel), the Company s four larges customers during the year ended March 31, 2004, represented approximately 61.1% of net sales for the year. See Item 4. Information on the Company Major Customers .

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Minority Interest Minority interests represent a 29% minority interest in Integrated International Limited, the holding company holding the capital stock of Deswell s electronic and metallic subsidiaries and a 49% minority interest in the subsidiary conducting marketing for Deswell s plastic and electronic businesses. In January 2003, the Company acquired an additional 20% interest in Integrated, increasing its ownership in that subsidiary from 51% to 71%. Despite the decrease in minority interest in Deswell s electronic & metallic segment, the dollar amount of minority interest increased to $1,957,000 for the year ended March 31, 2004, from $1,288,000 for the year ended March 31, 2003, which reflects that both the electronics and metallic subsidiaries and marketing subsidiary generated more net income in the fiscal 2004 as compared to fiscal 2003.

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

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

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

Year ended March 31, 2003 Compared to Year Ended March 31, 2002

Net Sales. The Company s net sales for the year ended March 31, 2003 were $90,905,000, an increase of $7,585,000 or 9.1% as compared to year ended March 31, 2002. Sales to Inter-Tel , Kyocera Mita Industrial Co. (H.K.) Ltd. (Mita), VTech , Epson and Digidesign, Inc., the Company s five largest customers during the year ended March 31, 2003, represented approximately 71.3% of net sales for the year.

The increase in sales during the year ended March 31, 2003 was mainly related to the increase in sales of plastic segment of $2,403,000 and the increase in sales of electronic and metallic segment of $5,182,000. This represented an increase of 5.1% and 14.5%, respectively, as compared with respective net sales from these segments in the prior year. The increase in net sales in both segments was mainly due to an increase in orders from existing customers, together with orders from new customers.

Net sales to customers by geographic area are determined by reference to shipping destinations as directed by the Company s customers. During the year ended March 31, 2003, sales to China, the United States and Europe and increased by $6,627,000, $6,574,000 and $3,382,000, respectively, and sales to Hong Kong and other areas decreased by $8,852,000 and $145,000, respectively, over levels for the year ended March 31, 2002.

Gross Profit. The gross profit for the year ended March 31, 2003 was $29,899,000, representing a gross profit margin of 32.9%. This compares with the overall gross profit and gross profit margin of $28,872,000 or 34.7% for the year ended March 31, 2002. The slight decrease in gross profit margin primarily relates to the mix of products sold.

Gross profit in the plastic segment increased by 0.9%, to $21,463,000 or 43.0% of net sales, for fiscal year ended March 31, 2003 compared to $21,280,000 or 44.8% of net sales, for fiscal 2002.

Gross profit in the electronic & metallic segment increased by 11.1%, to $8,436,000 or 20.6% of net sales, for fiscal year ended March 31, 2003 compared to $7,592,000 or 21.2% of net sales, for fiscal 2002. The increase was primarily attributed to the increase in net sales, despite the slight decrease in gross profit margin in both segments.

Selling, general and administrative expenses. SG&A expenses for the year ended March 31, 2003 were $15,354,000, amounting to 16.9% of total net sales, as compared to $14,939,000 or 17.9% of total net sales for the year ended March 31, 2002.

SG&A expenses in the plastic segment increased by $626,000 or 7.0%, to $9,557,000 or 19.1% of net sales, for the year ended March 31, 2003 compared to $8,931,000 or 18.8% of net sales, for fiscal 2002. SG&A expenses in the electronic & metallic segment decreased by $211,000 or 3.5%, to $5,797,000 or 14.1% of net sales, for fiscal year ended March 31, 2003 compared to $6,008,000 or 16.8% of net sales, for fiscal 2002. The decrease in SG&A in electronic and metal segment was mainly attributed to the decrease in selling expenses, which were shifted to the plastic segment.

Operating income. Operating income was $14,545,000 for the year ended March 31, 2003, an increase of $612,000 or 4.4% as compared with the prior year. On a segment basis, the operating income of plastic segment decreased $443,000 to $11,906,000, or 23.9% of net sales, in fiscal 2003 compared to $12,349,000, or 26.0% in net sales in fiscal 2002. This decrease in operating income is attributable to the increase in SG&A expenses offsetting the increase in gross profit described above. The operating income of electronic & metallic segment increased $1,055,000 to $2,639,000, or 6.4% of net sales in fiscal 2003, compared to $1,584,000 or 4.4% of net sales in fiscal 2002. This increase in operating income is attributable to the increase in gross profit and the decrease in SG&A expenses described above.

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

Income tax expense was $3,826,000 for the year ended March 31, 2003, compared to $535,000 for the prior year. The increase was primarily the result of the tax provision of $3,532,000, offset by a provision for a tax refund of $322,000 resulting from the reinvestment of part of the retained earnings in one of the Company s plastic manufacturing subsidiaries in China.

Minority Interest. Minority interests represent a 29% minority interest in Integrated International Limited, the holding company holding the capital stock of Deswell s electronics and metallic subsidiaries and a 49% minority interest in Jetcrown & Kwanasia (OEM) Specialist Limited, the subsidiary conducting marketing for Deswell s plastic and electronic businesses. In January 2003, the Company acquired an additional 20% interest in Integrated, increasing its ownership in that subsidiary from 51% to 71%. Despite the decrease in minority interest in Deswell s electronic & metallic segment, the dollar amount of minority interest increased to $1,288,000 for the year ended March 31, 2003, from $925,000 for the year ended March 31, 2002, which reflects that both the electronics and metallic subsidiaries and Deswell s marketing subsidiary generated more net income in the fiscal 2003 as compared to fiscal 2002.

Net Income. Net income was $10,243,000 for the year ended March 31, 2003, a decrease of $3,081,000 or 23.1%, as compared to the year ended March 31, 2002, and net income as a percentage of net sales decreased to 11.3% from 16.0%. The decrease in net income for fiscal 2003 was primarily the result of the tax provision of $3.5 million made as a result of the settlement in July 2003 of the tax dispute with the IRD.

Net Income for the plastic segment decreased 18.0% to $10,223,000 for fiscal 2003 compared to $12,469,000 for fiscal 2002. The decrease in net income of the plastic segment was mainly the result of the increase in income taxes described above. Net Income for the electronic & metallic segment decreased 97.7% to $20,000 for fiscal 2003 compared to $855,000 for fiscal 2002. The decrease in net income of the electronic & metallic segment was mainly the result of the increase in income taxes and the increase in the dollar amount of Deswell s minority interest in Integrated, as described above.

Seasonality

The following table sets forth certain unaudited quarterly financial information for the twelve quarters in the three-year period ended March 31, 2004 (in thousands):

Year ended March 31,		
2002	**2003**	**2004**

	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Net sales	$21,884	$22,189	$20,217	$19,030	$23,305	$22,603	$25,272	$19,725	$26,075	$25,079	$24,784	$21,257
Gross profit	7,523	7,564	7,225	6,560	7,447	7,733	8,473	6,246	8,411	7,980	8,401	6,298
Operating income	3,956	3,806	3,447	2,724	3,532	3,665	4,583	2,765	4,646	4,511	4,403	2,812
Net income	3,369	3,635	3,430	2,890	3,691	3,672	3,787	(907)	4,354	4,121	3,535	2,710

The first calendar quarter (the fourth quarter of the fiscal year) is typically the Company s slowest sales period because, as is customary in China, the Company s manufacturing facilities in China are closed for two weeks for the Chinese New Year holidays. The Company does not experience any other significant seasonal fluctuations.

Impact of Inflation

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

Exchange Rates

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

In 1994, China adopted a floating currency system whereby the official exchange rate is equal to the market rate. Since the market and official Yuan rates were unified, the value of the Yuan against the dollar has been essentially stable, with an average rate of 8.28 Yuan per $1.00 during Deswell s fiscal years ended March 31, 2002, 2003 and 2004. The Company believes, because its Chinese operations presently are confined to manufacturing products for export or for customers in China that are controlled by foreign investors and which pay the Company in Hong Kong dollars, that the current economic climate in China should not have a direct adverse impact on the Company s business.

The Company did not hedge its currency risk during the years ended March 31, 2002, 2003 or 2004 and at March 31, 2004, the Company had no open forward currency contracts. The Company continues to review its hedging strategy and there can be no assurance that hedging techniques implemented by the Company will be successful or will not result in charges to the Company s results of operations.

Liquidity and Capital Resources

For the year ended March 31, 2004, net cash generated from operations totaled $15,225,000, including net income of $14,720,000 and depreciation and amortization of $4,402,000. Accounts receivable and inventories increased by $2,230,000 and $1,390,000, respectively, over levels at March 31, 2003, primarily as a result of increases in sales and the general increase in business activities. Accounts payable increased by $1,525,000 over levels at March 31, 2003, primarily because of the increase materials purchases resulting from the increase in net sales. For the year ended March 31, 2003, net cash generated from operations totaled $19,842,000, including net income of $10,243,000 and depreciation and amortization of $4,692,000. Accounts receivable decreased by $161,000, and inventories increased by $1,559,000, over levels at March 31, 2002, primarily as a result of better controls over customers credit and the general increase in business activities. Accounts payable increased by $2,060,000 over March 31, 2002, primarily because of the increase materials purchases resulting from the increase in net sales.

Net cash used in investing activities amounted to $14,078,000 and $13,667,000 for the years ended March 31, 2004 and 2003, respectively. Capital expenditures during these periods totaled $19,862,000 and $9,731,000, respectively. Acquisition of marketable securities during these periods totaled $1,056,000 and $4,061,000, respectively. These were financed by cash generated from operations during each year and the proceeds from sale of marketable securities of $6,410,000 during the year ended March 31, 2004. The capital expenditure primarily related to the construction of our new Dongguan manufacturing plant and acquisition of plant and machinery for the Company s production facilities in China.

Net cash used in financing activities for the years ended March 31, 2004 and 2003 was $5,354,000 and $3,309,000, respectively. Net cash used in financing activities during the year ended March 31, 2004 was primarily to fund the Company s dividend payments to its shareholders of $8,569,000, dividend payments to minority shareholders of subsidiaries of $582,000 netting off the proceeds of $1,733,000 from the exercise of stock options from directors and employees and the release of restricted cash of $1,976,000. Net cash used in financing activities during the year ended March 31, 2003 was primarily to fund the Company s dividend payments to its shareholders of $6,687,000, dividend payments to minority shareholders of subsidiaries of $851,000 and repayment of short-term bank borrowings of $482,000 netting off the proceeds of $4,217,000 from the exercise of stock options from directors and employees. Cash of $495,000 was released as security for the short-term borrowing facilities during the year ended March 31, 2003.

As a consequence of the fixed exchange rate between the Hong Kong dollar and the U.S. dollar, interest rates on Hong Kong dollar borrowings are similar to U.S. interest rates. The Hong Kong Prime Rate was remained at 5.0% during the year ended March 31, 2004.

At March 31, 2004, the Company had cash and cash equivalents of $30,193,000 and committed credit facilities of $10,118,000, of which none had been used. The Company also had restricted cash of $390,000 and leasehold land and buildings of $1,288,000, which were pledged as collateral for those credit facilities. The Company expects that working capital requirements and capital additions will continue to be funded through cash on hand and internally generated funds. The Company s working capital requirements are expected to increase in line with the growth in the Company s business. The Company had capital commitments for construction of our Dongguan plastic injection-molding manufacturing plant, purchase of plant and machinery and purchase of our Dongguan electronic & metallic manufacturing plant of $2,449,000 as of March 31, 2004. The Company expects that internally generated funds will be sufficient to satisfy its cash needs for at least the next 12 months. The Company funded the payment of its tax settlement with the IRD discussed in Operating Results Year ended March 31, 2003 Compared to Year Ended March 31, 2002, above with cash on hand.

A summary of our contractual obligations and commercial commitments as of March 31, 2004 is as follows:

	(In thousands) Year ending March 31,					
Contractual obligation	**2005**	**2006**	**2007**	**2008**	**2009**	**2010 and thereafter**
Long-term bank borrowing	$	$	$	$	$	$
Capital (finance) lease obligations						
Operating lease payments	915	600	450	272		
Capital expenditures	2,449					
Purchase obligations	9,969	32	11	15	1	
Other long-term liabilities						

Total	$13,333	$632	$461	$287	$ 1	$

Off Balance Sheet Arrangements

We do not use off-balance sheet financing arrangements, such as securitization of receivables or obtaining access to assets through special purpose entities.

Critical Accounting Policies

The Company prepares its consolidated financial statements in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires the Company to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amount of revenues and expenses during the reporting period. On an on-going basis, the Company evaluates its estimates and judgments, including those related to inventories and the valuation of long-lived assets. The Company bases its estimates and judgments on historical experience and on various other factors that the Company believes are reasonable. Actual results may differ from these estimates under different assumptions or conditions.

The following critical accounting policies affect the more significant judgments and estimates used in the preparation of the Company s consolidated financial statements.

Inventories Inventories, consisting of raw materials, work-in-progress and finished goods, are stated at the lower of cost or market with cost determined using the first-in, first-out method. The Company makes certain obsolescence and other assumptions to adjust inventory based on historical experience and current information. The Company writes down inventory for estimated obsolete or unmarketable inventory equal to the difference between the costs of inventory and estimated market value, based upon assumptions about future demand and market conditions. These assumptions, although consistently applied, can have a significant impact on current and future operating results and financial position.

Valuation of long-lived assets The Company periodically evaluates the carrying value of long-lived assets to be held and used, including other intangible assets subject to amortization, when events and circumstances warrant such a review. The carrying value of a long-lived asset is considered impaired when the anticipated undiscounted cash flow from such asset is separately identifiable and is less than its carrying value. In that event, a loss is recognized based on the amount by which the carrying value exceeds the fair market value of the long-lived asset. Fair market value is determined primarily using the anticipated cash flows discounted at a rate commensurate with the risk involved. Losses on long-lived assets to be disposed of are determined in a similar manner, except that fair market values are reduced for the cost to dispose.

Recent Changes in Accounting Standards

In May 2003, the FASB issued SFAS No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity (SFAS 150). SFAS 150 established standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. This statement is effective for financial instruments entered into or modified after May 31, 2003 and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. The Company s adoption of this interpretation is not expected to have an effect on its consolidated financial statements.

In April 2003, the FASB issued SFAS No. 149, Amendment of Statement 133 on Derivative Instruments and Hedging Activities that amends and clarifies accounting for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities under Statement 133. With certain exceptions, SFAS No. 149 is effective for contracts entered into or modified after June 30, 2003, and for hedging relationships designed after June 30, 2003. Management does not expect the adoption of this standard to have a material impact on the Company s financial position or results of operations.

In November 2002, the FASB issued FASB Interpretation No. 45, Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others (FIN 45). FIN 45 requires a guarantor to recognize, at the inception of a qualified guarantee, a liability for fair value of the obligation undertaken in issuing the guarantee. FIN 45 is effective on a prospective basis for qualified guarantees issued or modified after December 31, 2002. Management does not expect the adoption of this Interpretation to have a material impact on the Company s financial position or results of operations.

In January 2003, the FASB issued FASB Interpretation No. 46, Consolidation of Variable Interest Entities (FIN 46). FIN 46 explains how to identify variable interest entities and how an enterprise assesses its interest in a variable interest entity to decide whether to consolidate that entity. This Interpretation requires existing

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unconsolidated variable interest entities to be consolidated by their primary beneficiaries if the entities do not effectively disperse risks among parties involved. FIN 46 is effective immediately for variable interest entities created after January 31, 2003, and to variable interest entities in which an enterprise obtains an interest after that date. Management does not expect the adoption of this Interpretation to have a material impact on the Company s financial position or results of operation.

In December 2003, the FASB issued Interpretation No. 46R, a revision to Interpretation No. 46, Consolidation of Variable Interest Entities , which addresses how a business enterprise should evaluate whether it has a controlling financial interest in an entity through means other than voting rights and accordingly should consolidate the entity. Interpretation No. 46R clarifies some of the provisions of Interpretation No. 46 and exempts certain entities from its requirements. Interpretation No. 46R is effective at the end of the first interim period ending March 15, 2004. Management does note expect the adoption of this statement to have a material impact on the Company s financial position or results of operations.

ITEM 6. DIRECTORS, SENIOR MANAGEMENT AND EMPLOYEES

Directors and Senior Management

The directors and executive officers of the Company at June 30, 2004 are as follows:

Name	Age	Position(s) with Company
Lau Pui Hon (Richard Lau)	59	Chief Executive Officer and Chairman of the Board of Directors
Li Chin Pang (C. P. Li)	58	Executive Director and General Manager of Manufacturing and Administration for Plastic Operations, Chief Financial Officer, Secretary and Member of the Board of Directors
Leung Chi Wai (C. W. Leung)	49	Executive Director of Engineering for Plastic Operations and Member of the Board of Directors
Lee Shu Kwan (S. K. Lee)	58	Director of Administration and Marketing for Electronic Operations
Tam Man Chi (M. C. Tam)	54	Director of Engineering and Manufacturing for Electronic Operations
Dickson Lam	62	Director of Marketing for Plastic and Electronics Operations
Eliza Y. P. Pang	42	Financial Controller
Hung-Hum Leung	58	Member of Board of Directors and Audit Committee

Allen Yau-Nam Cham	57	Member of Board of Directors and Audit Committee

Richard Lau. Mr. Lau has served as Chief Executive Officer and Chairman of the Board of Directors of the Company and its predecessors since their inception in 1987.

C. P. Li. Mr. Li has served the Company as a Member of the Board of Directors and in various executive capacities with the Company and its predecessors since their inception in 1987. He became Secretary of the Company in February 1995 and Chief Financial Officer in May 1995. As Executive Director and General Manager of Manufacturing and Administration for Plastic Operations, Mr. Li is in charge of the day-to-day manufacturing and administrative operations for the Company s plastic products. Mr. Li received his Bachelor of Science degree from Chun Yan Institute College, Taiwan in 1967.

C. W. Leung. Mr. Leung has served the Company as a Member of the Board