

DESWELL INDUSTRIES INC

Form 20-F

July 16, 2004

Table of Contents

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

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 No

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

Item 17 Item 18

TABLE OF CONTENTS

	<u>Financial Statements and Currency Presentation</u>	2
<u>PART I</u>		
<u>Item 1.</u>	<u>Identity of Directors, Senior Management and Advisors</u>	3
<u>Item 2.</u>	<u>Offer Statistics and Expected Timetable</u>	3
<u>Item 3.</u>	<u>Key Information</u>	3
<u>Item 4.</u>	<u>Information on the Company</u>	10
<u>Item 5.</u>	<u>Operating and Financial Review and Prospects</u>	22
<u>Item 6.</u>	<u>Directors, Senior Management and Employees</u>	31
<u>Item 7.</u>	<u>Major Shareholders and Related Party Transactions</u>	34
<u>Item 8.</u>	<u>Financial Information</u>	37
<u>Item 9.</u>	<u>The Offer and Listing</u>	38
<u>Item 10.</u>	<u>Additional Information</u>	39
<u>Item 11.</u>	<u>Quantitative and Qualitative Disclosure about Market Risk</u>	51
<u>Item 12.</u>	<u>Description of Securities Other than Equity Securities</u>	51
<u>PART II</u>		
<u>Item 13.</u>	<u>Defaults, Dividend Arrearages and Delinquencies</u>	52
<u>Item 14.</u>	<u>Material Modifications to the Rights of Security Holders and Use of Proceeds</u>	52
<u>Item 15</u>	<u>Controls and Procedures</u>	52
<u>Item 16A</u>	<u>Audit Committee Financial Expert</u>	52
<u>Item 16B</u>	<u>Code of Ethics</u>	52
<u>Item 16C</u>	<u>Principal Accountant Fees and Services</u>	52
<u>Item 16D</u>	<u>Exemptions for the Listing Standards for Audit Committee</u>	53
<u>Item 16E</u>	<u>Purchases of Equity Securities by the Issuer and Affiliated Purchasers</u>	53
<u>PART III</u>		
<u>Item 17.</u>	<u>Financial Statements</u>	53
<u>Item 18</u>	<u>Financial Statements</u>	54
<u>Item 19</u>	<u>Exhibits</u>	55
<u>SIGNATURES</u>		57
<u>Exhibit 4.1</u>		
<u>Exhibit 4.3</u>		
<u>Exhibit 4.11</u>		
<u>Exhibit 4.12</u>		
<u>Exhibit 4.13</u>		
<u>Exhibit 11.1</u>		
<u>Exhibit 12.1</u>		
<u>Exhibit 12.2</u>		
<u>Exhibit 13.1</u>		
<u>Exhibit 14.1</u>		
<u>Exhibit 14.2</u>		

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 subsidiaries 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.

Table of Contents**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).

Table of Contents

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.

Table of Contents

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.

Table of Contents

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

Table of Contents

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.

7

Table of Contents

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

Table of Contents

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.

Table of Contents**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,

Table of Contents

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.

Table of Contents

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:

	<u>2002</u>	<u>2003</u>	<u>2004</u>
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.

Table of Contents

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

Table of Contents

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

Table of Contents

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

Table of Contents

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.

Table of Contents

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.

Table of Contents

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,

Table of Contents

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.

Customer	Product	Year ended March 31,		
		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.

Table of Contents

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.

Table of Contents

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

Table of Contents

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.

Table of Contents

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-Electronic & Molding Segment		Total	Plastic Injection-Electronic & Molding Segment		Total	Plastic Injection-Electronic & Molding Segment		Total
	Molding Segment	Metallic Segment		Molding Segment	Metallic Segment		Molding Segment	Metallic Segment	
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

Edgar Filing: DESWELL INDUSTRIES INC - Form 20-F

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%

Table of Contents**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 largest 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

Table of Contents

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.

Table of Contents

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.

Table of Contents

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

Table of Contents

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,

Table of Contents

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:

Contractual obligation	(In thousands)					
	Year ending March 31,					
	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	\$
	<u> </u>	<u> </u>	<u> </u>	<u> </u>	<u> </u>	<u> </u>

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.

Table of Contents

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

Table of Contents

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 not 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 of Directors and in various executive capacities with the Company and its predecessors since their inception in 1987. As Executive Director of Engineering for Plastic Operations, Mr. Leung is in charge of the mold division and engineering for the Company's plastic manufacturing operations.

Table of Contents

S. K. Lee. Mr. Lee has served as Director of Administration and Marketing for Electronic Operations since the Company acquired its majority interest in Kwanasia, Integrated's predecessor, in 1992 and has served as the Chief Executive Officer of Kwanasia and Integrated since Kwanasia's inception in 1986. As Director of Administration and Marketing for Electronic Operations, Mr. Lee is in charge of the Company's day-to-day administrative and marketing operations for electronic products. Mr. Lee received his Bachelor of Science degree in Electronic Engineering from National Taiwan University in 1967.

M. C. Tam. Mr. Tam has served as Director of Engineering and Manufacturing for Electronic Operations since the Company acquired its majority interest in Kwanasia, Integrated's predecessor, in 1992 and has served in a similar capacity for Kwanasia and Integrated since Kwanasia's inception in 1986. As Director of Engineering and Manufacturing for Electronic Operations, Mr. Tam is in charge of the Company's day-to-day contract manufacturing activities for electronic products. Mr. Tam received his Bachelor of Science degree with a major in physics and minor in electronics from the Chinese University of Hong Kong in 1973.

Dickson Lam. Mr. Lam has served as the Company's Director of Marketing since April 1990 and assumed the title of Director of Marketing for Plastic and Electronic Operations in August 2001.

Eliza Y. P. Pang. Ms. Pang has served as the Company's Financial Controller since January 1995. She is a registered fellow member of The Association of Chartered Certified Accountants. Ms. Pang has worked at KPMG and Ernst & Young in Hong Kong. Ms. Pang received her Professional Diploma in Accountancy and her MBA degree from The Hong Kong Polytechnic University in 1985 and 1996, respectively.

Hung-Hum Leung. Mr. Leung has been a director of the Company and member of the Audit Committee since December 1999. Mr. Leung has over 25 years of experience in the manufacture of electronic products. Mr. Leung was the founder of Sharp Brave Holdings Ltd., a Hong Kong public company listed on the Hong Kong Stock Exchange, and from 1991 to 1995 served as the Chairman of Sharp Brave Holdings Ltd. Since 1995, Mr. Leung has been an independent consultant to the electronics industry. He received his Bachelor of Science degree in Physics from the National Taiwan University in 1971.

Allen Yau-Nam Cham. Mr. Cham has been a director of the Company and member of the Audit Committee since August 2003. Mr. Cham has been the Managing Director and shareholder of Kwong Fat Hong (Securities) Limited since 1995. He has over 20 years of experience in the securities industry. He is a Certified General Accountant in Canada. He obtained his Bachelor of Science degree from St. Mary's University, Halifax, Canada, Bachelor of Engineering (Electrical) degree from Nova Scotia Technical College, Halifax, Canada and Master of Business Administration degree from University of British Columbia, Canada.

No family relationship exists among any of the named directors, executive officers or key employees. No arrangement or understanding exists between any director or officer and any other persons pursuant to which any director or executive officer was elected as a director or executive officer of the Company.

Compensation of Directors and Senior Managers

Executive Officers

The aggregate amount of compensation (including non-cash benefits) paid by the Company and its subsidiaries during the year ended March 31, 2004 to all directors and officers as a group for services in all capacities was approximately \$2,605,000. This excludes amounts paid by the Company to shareholders as dividends during the year ended March 31, 2004.

Directors

Effective August 1, 2003, directors who are not employees of the Company or any of its subsidiaries are paid \$2,000 per month for services as a director, respectively, and are reimbursed for all reasonable expenses incurred in connection with services as a director.

Table of Contents

Board Practices

The directors of the Company are elected at its annual meeting of shareholders and serve until their successors take office or until their death, resignation or removal. The executive officers serve at the pleasure of the Board of Directors of the Company.

The Audit Committee meets from time to time to review the financial statements and matters relating to the audit and has full access to management and the Company's auditors in this regard. The Audit Committee recommends the engagement or discharge of the Company's independent accountants, consults on the adequacy of the Company's internal controls and accounting procedures and reviews and approves financial statements and reports. Deswell's audit committee consists of Messrs. Hung-Hum Leung and Allen Yau-Nam Cham.

Although the Company does not currently have a compensation or remuneration committee or a nominating committee, Deswell plans to create them in time to comply with the rules of the Nasdaq Stock Market that are applicable to foreign private issuers by July 31, 2005.

Employees

At March 31, 2004, the Company employed 4,900 persons on a full-time basis, of which 16 were located in Macao and Hong Kong and 4,884 in China. Of the Company's employees 3,500, 955 and 445 were engaged in plastic injection molding manufacturing, contract electronic manufacturing and metal molds and parts manufacturing, respectively, at March 31, 2004. The Company has not experienced significant labor stoppages. Management believes that relations with the Company's employees are satisfactory.

Share Ownership

Share Ownership of Directors and Senior Management

For information concerning the beneficial ownership of the Company's common shares by Directors and Senior Management and major shareholders, see Item 7 of this Report.

Employee Stock Option Plans

In 1995, the Company adopted its 1995 Stock Option Plan permitting the Company to grant options to purchase up to 675,000 common shares to employees, officers, directors and consultants of the Company. On September 29, 1997, the Company's Board of Directors and shareholders approved an increase of 366,000 shares in the number of shares that can be optioned and sold under the Option Plan bringing to a total of 1,041,000 shares the number of common shares that can be optioned and sold under the 1995 Stock Option Plan.

On August 15, 2001 the Board approved the adoption of the 2001 Stock Option Plan permitting the Company to grant options to purchase up to an additional 750,000 common shares to employees, officers, directors and consultants of the Company. On January 7, 2002 shareholders approved the 2001 plan.

On August 20, 2003, the Board approved the adoption of the 2003 Stock Option Plan permitting the Company to grant options to purchase up to an additional 600,000 common shares to employees, officers, directors, consultants and advisors of the Company. On September 30, 2003 shareholders approved the 2003 plan.

The Company's option plans are administered by the Board of Directors, which determines the terms of options granted, including the exercise price, the number of shares subject to the option and the option's exercisability. The

exercise price of all options granted under the option plans must be at least equal to the fair market value of such shares on the date of grant. The maximum term of options granted under the option plans is 10 years.

At June 30, 2004, options to purchase an aggregate of 2,391,000 Common Shares had been granted under the option plans, options to purchase an aggregate of 1,149,500 Common Shares were outstanding and no options to purchase Common Shares were available for future grant under the option plans.

Table of Contents**ITEM 7. MAJOR SHAREHOLDERS AND RELATED PARTY TRANSACTIONS**

Except as disclosed in the footnotes to the table below with respect to Leesha Holdings Limited (Leesha), the Company is not directly owned or controlled by another corporation or by any foreign government. The following table sets forth, as of June 30, 2004, the beneficial ownership of the Company's Common Shares by each person known by the Company to beneficially own 5% or more of the Common Shares of the Company and by each of the Directors and Senior Management of the Company who beneficially own in excess of one percent of the Company's Common Shares.

Name of beneficial owner or identity of group	Number of shares beneficially owned (1)	
	Amount	Percent
Richard Lau	2,738,117	29.0%
C. P. Li	2,728,365	28.9%
C. W. Leung	2,559,500	27.2%
Leesha Holdings Ltd.	2,302,500	25.2%
Royce & Associates, Inc. ⁽⁶⁾	941,650	10.3%
FMR Corp./ Edward C. Johnson 3d ⁽⁷⁾	877,150	9.6%
Micropower Enterprises Limited	682,500	7.5%
Wellington Management Company, LLP ⁽⁸⁾	590,032	6.4%
M. C. Tam	159,940	1.7%
S. K. Lee	155,740	1.7%
Dickson Lam	*	*
Eliza Y. P. Pang	*	*
Hung-Hum Leung	*	*
Allen Yau-Nam Cham	*	*

* Less than 1%.

(1) Based on 9,149,085 Common Shares outstanding on June 30, 2004. However, in accordance with Rule 13d-3(d)(1) under the Securities Exchange Act of 1934, Common Shares not outstanding but which are the subject of currently exercisable options have been considered outstanding for the purpose of computing the percentage of outstanding Common Shares owned by the listed person holding such options, but are not considered outstanding for the purpose of computing the percentage of Common Shares owned by any of the other listed persons.

(2) Consists of 2,302,500 Common Shares held of record by Leesha, 135,617 Common Shares held of record by Mr. Lau and options to purchase 300,000 Common Shares granted to Mr. Lau under the Company's stock option plans. Mr. Lau's options are exercisable at a weighted average exercise price of \$14.28 per share until September 30, 2013. As a director of Leesha, Mr. Lau shares the voting and investment power of the Common Shares held by Leesha.

(3) Consists of 2,302,500 Common Shares held of record by Leesha, 125,865 Common Shares held of record by Mr. Li and options to purchase 300,000 Common Shares granted to Mr. Li under the Company's stock option plans. Mr. Li's options are exercisable at a weighted average exercise price of \$14.28 per share until September 30, 2013. As a director of Leesha, Mr. Li shares the voting and investment power of the Common Shares held by Leesha.

(4) Consists of 2,302,500 Common Shares held of record by Leesha, 2,000 Common Shares held of record by Mr. Leung and options to purchase 255,000 Common Shares granted to Mr. Leung under the Company's stock option plans. Mr. Leung's

Table of Contents

options are exercisable at a weighted average exercise price of \$14.80 per share until September 30, 2013. As a director of Leesha, Mr. Leung shares the voting and investment power of the Common Shares held by Leesha.

(5) Leesha is an investment holding company organized as an International Business Company under the laws of the British Virgin Islands. Messrs. Lau, Li and Leung, who are its directors, wholly own Leesha in equal shares. Among other investments, Leesha owns the 2,302,500 Common Shares of Deswell, which were transferred to Leesha by Messrs. Lau, Li and Leung after Deswell's initial public offering.

(6) Based on Amendment No. 1 to a Schedule 13G filed with the SEC on April 4, 2004.

(7) Based on Amendment No. 1 to a Schedule 13G filed with the SEC on February 17, 2004.

(8) Based on a Schedule 13G filed with the SEC on February 12, 2004.

The following table reflects the percentage ownership of Deswell's common shares by its major shareholders during the past three years:

	Percentage Ownership (1) at		
	June 28, 2002	Aug. 28, 2003	June 30, 2004
Richard Lau	33.2%	29.7%	29.0%
C. P. Li	33.4%	29.6%	28.9%
C. W. Leung	33.0%	28.5%	27.2%
Leesha Holdings Ltd.	27.2%	25.3%	25.2%
Royce & Associates, Inc.	6.3%	9.3%	10.3%
FMR Corp./ Edward C. Johnson 3d/ Abigail P. Johnson		9.2%	9.6%
Micropower Enterprises Limited	8.1%	7.5%	7.5%
Wellington Management Company, LLP			6.5%

(1) Based on 8,396,896, 8,470,246 and 9,149,085 common shares outstanding on June 28, 2002, August 28, 2003 and June 30, 2004, respectively. However, in accordance with Rule 13d-3(d)(1) under the Securities Exchange Act of 1934, common shares not outstanding but which are the subject of currently exercisable options have been considered outstanding for the purpose of computing the percentage of outstanding common shares owned by the listed person holding such options, but are not considered outstanding for the purpose of computing the percentage of common shares owned by any of the other listed persons.

All of the holders of the Company's common shares (including Deswell's major shareholders) have equal voting rights with respect to the common shares held. As of June 30, 2004, approximately 32 holders of record, who, management believes, held for more than 3,000 beneficial owners, held Deswell's common shares. According to information supplied to the Company by its transfer agent, at June 30, 2004, 24 holders of record with addresses in the United States held approximately 6.3 million of our outstanding common shares.

Table of Contents**Related Party Transactions**

During the year ended March 31, 2002, sales to Nam Tai Electronic (Shenzhen) Co. Limited (Namtai Shenzhen) amounted to less than 10% of the Company's total sales. Namtai Shenzhen is an indirect wholly owned subsidiary of Nam Tai Electronics, Inc. (Nam Tai), which, in September 2000, purchased an aggregate of 750,000 Common Shares of the Company, equal to approximately 9% of the Company's then outstanding Common Shares. During the year ended March 31, 2002, Nam Tai sold its shares of the Company in the open market.

In the past, the Company rented staff quarters in China from Mr. S. K. Lee and Mr. M. C. Tam, who are executive officers of the Company and minority shareholders of Integrated International Limited, the parent holding company of the Company's electronic and metallic subsidiaries. The charges for these premises approximate the amount negotiable, in management's opinion, on an arms length basis. Rentals charged by these parties to the Company are summarized as follows:

	Year ended March 31,		
	2002	2003	2004
Rent charged by Mr. S. K. Lee and Mr. M. C. Tam	\$ 12,000	Nil	Nil

In January 2003, the Company issued to each of Messrs. Lee and Tam 125,940 of its Common Shares, or an aggregate of 251,880 Common Shares, to acquire an additional 20% (10% from each of Messrs. Lee and Tam) shareholding interest in Integrated raising the Company's interest in Integrated to 71% of its outstanding shares. Messrs. Lee and Tam continue as minority shareholders of Integrated each owning 12% (together 24%) of its outstanding shares and continue to serve as the executives in charge of administrative and manufacturing operations for the Company's contract manufacturing operations for electronic products and subassemblies. At the time of the closing of this transaction on January 20, 2003, the market value of the 251,880 Deswell shares issued to Messrs. Lee and Tam was \$4,423,000, based on the closing price on that date of \$17.56 per share as reported on The Nasdaq Stock Market. During the years ended March 31, 2002, 2003 and 2004, Integrated made distributions to its shareholders, including Deswell, aggregating \$nil, \$1,609,000 and \$426,000, respectively, with Messrs. Lee and Tam's share of these distributions aggregating \$nil, \$708,000 and \$102,000, respectively.

During the year ended March 31, 2002, 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 electronics businesses. The capital stock of J&K OEM is 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. During the years ended March 31, 2002, 2003 and 2004, J&K OEM made distributions to its shareholders, including Deswell, aggregating \$nil, \$129,000 and \$935,000, respectively, with Mr. Lam's share of these distributions amounting to \$nil, \$50,000 and \$365,000, respectively. 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 another 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. During the year ended March 31, 2004, Triumph Wise did not make any distributions to its shareholders.

Since the Company completed its initial public offering in the United States, it has been Deswell's policy that all transactions between Deswell and any interested director or executive officer be approved by a majority of the disinterested directors and be on terms that are no more favorable than would be available from an independent third party.

Table of Contents

ITEM 8. FINANCIAL INFORMATION

Financial Statements

Our Consolidated Financial Statements are set forth under Item 18. Financial Statements.

Legal Proceedings

The Company is not involved in any material legal proceedings.

Exports Sales

Information regarding our export sales is provided in Item 4. Information on the Company Business Overview Customers and Marketing.

Dividend Policy

Dividends paid under Hong Kong law are tax free to the recipient. While the Company had paid dividends to its shareholders prior to its IPO, it discontinued payment of dividends after the IPO until its new dividend policy was announced in July 1996. At that time, the Company announced that it planned to pay cash dividends semi-annually in the form of an interim and final dividend based on the Company's growth during the preceding year. The Company announced that dividends would be 25% to 35% of the net earnings of the preceding year limited, however, by the net cash flow available for future development. The interim dividend would be based upon the Company's first six months operating results and would be paid between November and December and the final dividend would be based upon the Company's second six months of operations and would be declared and paid between July and August. Under this dividend policy, the Company declared and paid dividends during the year ended March 31, 2002 aggregating \$7,229,000, \$3,193,000 of which was based on results for the second six months of the year ended March 31, 2001 and \$4,036,000 of which was based on results for the first nine months of the year ended March 31, 2002.

Commencing with the fiscal year ended March 31, 2003, the Company announced it would pay cash dividends on a quarterly basis based upon the Company's quarterly results. Under this dividend policy, the Company declared and paid dividends during the year ended March 31,

2003 aggregating \$6,687,000, \$1,578,000 of which was based on results for the last quarter of the year ended March 31, 2002 and \$5,109,000 of which was based on results for the first three quarters of the year ended March 31, 2003; and

2004 aggregating \$8,569,000, \$2,002,000 of which was based on results for the last quarter of the year ended March 31, 2003 and \$6,567,000 of which was based on results for the first three quarters of the year ended March 31, 2004.

The Company currently plans to continue its quarterly dividend policy as announced, but such plans and policy for future dividends consist of forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. Whether future dividends will be declared will be depended upon the Company's future growth and earnings, of which there can be no assurance, and the Company's cash flow needs for future development, which growth, earning or cash flow needs may be adversely affected by one or more of the factors discussed in Item 3. Key Information Risk Factors. Accordingly, there can be no assurance that future cash dividends on the Company's common shares will be declared, what the amounts of such dividends will be or whether such dividends, once declared for a specific period will continue for any future period or at all.

Table of Contents**ITEM 9. THE OFFER AND LISTING**

The Company's common shares are traded exclusively on The Nasdaq National Market under the symbol **DSWL**.

The following table sets forth the high and low sale prices as reported by The Nasdaq National Market for each of the last five years ended March 31 (adjusted for the Company's three-for-two stock split effected in July 2002):

Year Ended	High	Low
March 31, 2004	\$30.60	\$15.64
March 31, 2003	18.15	11.00
March 31, 2002	14.75	8.75
March 31, 2001	12.00	8.17
March 31, 2000	12.33	5.29

The following table sets forth the high and low sale prices as reported by The Nasdaq National Market during each of the quarters in the two-year period ended March 31, 2003 and the average daily trading volume during each of the quarters (adjusted for the Company's three-for-two stock split effected in July 2002)

Quarter ended	High	Low	Average Daily Trading Volume(1)
March 31, 2004	\$29.00	\$23.59	12,330
December 31, 2003	30.60	21.02	14,103
September 30, 2003	25.75	17.89	12,014
June 30, 2003	21.52	15.64	9,023
March 31, 2003	18.15	14.40	6,905
December 31, 2002	14.75	12.65	9,882
September 30, 2002	15.00	11.00	9,686
June 30, 2002	15.77	12.34	8,498

(1) Determined by dividing the sum of the reported daily volume for the quarter by the number of trading days in the quarter.

The following table sets forth the high and low sale prices as reported by The Nasdaq National Market during each of the most recent six months and the average daily trading volume during each of the months.

Month ended	High	Low	Average Daily Trading Volume(1)
June 30, 2004	\$24.75	\$21.80	2,902
May 31, 2004	25.00	21.51	3,499
April 30, 2004	27.22	24.05	6,497
March 31, 2004	27.73	23.59	12,237

Edgar Filing: DESWELL INDUSTRIES INC - Form 20-F

February 29, 2004	27.90	24.51	13,418
January 31, 2004	29.00	25.64	11,404

(1) Determined by dividing the sum of the reported daily volume for the month by the number of trading days in the month.

38

Table of Contents

ITEM 10. ADDITIONAL INFORMATION

Share Capital

Not applicable.

Memorandum and Articles of Association

Objects and Purposes

Our objects and purposes are described in Clause 4 of our Memorandum of Association and are generally to engage in any act or activity that is not prohibited under the laws of the British Virgin Islands.

Directors

British Virgin Islands law and our Articles of Association provide that no agreement or transaction between Deswell and one or more of its directors or any entity in which any director has a financial interest or to whom any director is related (including as a director of that other entity) is void or voidable for this reason only or by reason only that the director is present at the meeting of directors, or at the meeting of the committee of directors, that approves the agreement or transaction or that the vote or consent of the director is counted for the purpose if the material facts of the interest of each director in the agreement or transaction and his or her interest in or relationship to any other party to the agreement or transaction are disclosed in good faith or are known by the other directors and a majority of the Company's directors (at least one whom is an Independent Director) approve such transaction. Alternatively, the interest in the transaction may be disclosed or known to or ratified by the shareholders.* In addition, a director who has an interest in any particular business to be considered at a meeting of directors or shareholders may be counted for the purposes of determining whether the meeting is duly constituted. An Independent Director is defined in our Articles of Association as a director other than an officer or employee of Deswell or any of its subsidiaries, a person related to an officer or employee of Deswell or any of its subsidiaries, a person representing family or concentrated (more than 10%) holdings of Deswell's outstanding voting shares or any other individual having a relationship which, in the opinion of the directors, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director.

Our Articles of Association provide that the directors may by a resolution of directors, fix the emoluments of directors with respect to services to be rendered in any capacity to the Company.

British Virgin Islands law and our Articles of Association provide that the management of the business and the control of Deswell shall be vested in the directors, who in addition to the powers and authorities expressly conferred by the Articles of Association, may also exercise all such powers, and do all such acts and things, as may be done by Deswell and are not by the Articles of Association or British Virgin Islands law expressly directed or required to be exercised or done by a meeting of shareholders. Our Articles of Association provide that the directors may by resolution exercise all the powers of Deswell to borrow money and to mortgage or charge its undertakings and property or any part thereof, to issue debentures, debenture stock and other securities whenever money is borrowed or as security for any debt, liability or obligation of Deswell or of any third party.

British Virgin Islands law and our Memorandum of Association and Articles of Association do not contain an age limit requirement for our directors. Under our Articles of Association, no shares are required for director's qualification.

*

British Virgin Islands law does not use the term shareholder or stockholder but rather refers to holders of shares of a company, like Deswell, organized under the International Business Companies Act as members. In this Report, for the convenience of our U.S. holders, we use the term shareholders rather than members.

Table of Contents

Rights, Preferences and Restrictions of Authorized and Outstanding Shares and Changes to Rights of Shareholders

Deswell has one class and series of shares authorized or outstanding: common shares, no par value per share. Our authorized capital consists of 30,000,000 common shares, no par value per share, of which 9,149,085 common shares were outstanding on June 30, 2004.

Holders of our common shares are entitled to one vote for each whole share on all matters to be voted upon by shareholders, including the election of directors. Holders of our common shares do not have cumulative voting rights in the election of directors. All of our common shares are equal to each other with respect to liquidation and dividend rights. Holders of our common shares are entitled to receive dividends if and when declared by our board of directors out of funds legally available under British Virgin Islands law. In the event of our liquidation, all assets available for distribution to the holders of our common shares are distributable among them according to their respective holdings. Holders of our common shares have no preemptive rights to purchase any additional, unissued common shares.

Calling Annual General Meetings and Extraordinary General Meetings of Shareholders.

British Virgin Islands law does not require an international business company, such as Deswell, to have an annual meeting. Our Articles of Association do, however, require an annual meeting of shareholders for the election of directors and for such other business as may come before the meeting.

Under British Virgin Islands law, unless otherwise provided by a company's Memorandum of Association or Articles of Association, the directors may call meetings of shareholders at any time. Our Memorandum and Articles of Association do not provide otherwise. Under British Virgin Islands law, unless otherwise provided by a company's Memorandum of Association or Articles of Association, directors are required to call meetings upon a written request from shareholders holding more than 50% of outstanding voting shares. Our Articles of Association provide that meetings of shareholders may be called only upon a written request from shareholders holding 10% or more of the outstanding voting shares.

British Virgin Islands law and our Articles of Association state that the directors may fix the date that notice is given of a meeting of shareholders, whether extraordinary or annual, as the record date for determining those shares that are entitled to vote at the meeting.

British Virgin Islands law and our Articles of Association provide that notice of all meetings of shareholders, stating the time, place and purposes thereof, shall be given not fewer than seven days before the date of the proposed meeting to those persons whose names appear as shareholders in our share register on the date of the notice and are entitled to vote at the meeting.

Limitations on Share Ownership

British Virgin Islands law and our Memorandum of Association and Articles of Association do not impose any limitations on the right of anyone to own, hold or exercising voting rights to our common shares.

Potential Anti-Takeover Deterrence

Neither our Articles of Association nor Memorandum of Association contain provisions that would have an effect of delaying, deferring or preventing a change in control of Deswell and that would operate only with respect to a merger, acquisition or corporate restructuring involving Deswell or any of its subsidiaries. However, pursuant to our Memorandum and Articles of Association and pursuant to the laws of the British Virgin Islands, our board of directors without shareholder approval may amend our Memorandum and Articles of Association (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 ability to amend our Memorandum and Articles of Association 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.

Table of Contents

Ownership Information

Neither our Articles of Association nor Memorandum of Association provide that information about our shareholders, even those owning significant percentages of our shares, must be disclosed.

Differences from United States Law

The laws of the British Virgin Islands governing the provisions of our Articles of Association and Memorandum of Association discussed above are not significantly different than the laws governing similar provisions in the charter documents of Delaware companies, other than with respect to amending our Memorandum of Association without shareholder approval. Delaware law requires shareholders to approve any amendments to a corporation's Certificate of Incorporation.

Material Contracts

The following summarizes each material contract, other than contracts entered into in the ordinary course of business, to which Deswell or any subsidiary of Deswell is a party for the two years immediately preceding the filing of this report. The Reference to an Exhibit is to the exhibits appearing in Item 19 of this report.

Banking Facilities (Exhibit 4.1)

Date: April 8, 2004

Parties: The Hongkong & Shanghai Banking Corporation Limited, Macao Branch (HSBC) and Jetcrown Industrial (Macao Commercial Offshore Limited (JIMCO)

Nature of Contract: HSBC provide JIMCO various general banking facilities.

Terms and Conditions: (1) Overdraft facility of HK\$5,000,000 (2) import facility of HK\$5,000,000. Interest on the overdraft facility is charged at 1 % per annum below bank's best lending rate.

Consideration: HSBC time deposit for HK\$5,000,000 (or other currency equivalent with interest accrual) held under lien to bank together with security over deposit & letter of set-off. Letter of awareness from Deswell Industries, Inc.

Banking Facilities (Exhibit 4.2)

Date: May 2, 2003

Parties: Standard and Kwanasia Electronics Co. Ltd. (Kwanasia)

Nature of Contract: Standard to provide Kwanasia with working capital facilities.

Terms and Conditions: Working Capital Facilities (1) Current Account Overdraft is HK\$1,000,000 ; (2) Trade Finance Group All 9 Discrepant Credit Bills Negotiated (with recourse) is HK\$5,000,000; (3) Trade Finance Group 1 is HK\$5,000,000; (4) Trade Finance Group 2 is HK\$4,000,000; (5) Trade Finance Group 3 HK\$4,000,000 (the trade finance groups all, 1, 2 and 3 are complementary and combined amounts outstanding are not to exceed HK\$5,000,000; combined amounts outstanding of Trade Finance Groups 2 and 3 are not to exceed HK\$4,000,000) (6) Treasury Facilities to quote rates for foreign exchange spot transactions and forward transactions;. Interest rate on all sums advanced will be payable monthly in arrears at Prime or HIBOR, whichever is higher. Default rate of 8% per annum

over Prime or HIBOR, whichever is higher will apply to amounts not paid when due or in excess of agreed facility amounts. Export bills will be discounted and import bills will be financed at Bank's standard bills finance rate minus 0.25% per annum for Hong Kong Dollar Bills and at Bank's standard bills finance rate for foreign currency bills. All past due bills shall bear interest at 4% per annum above the rates charged on regular bills outstanding. Commission on Letters of Credit Opening is -1/4% on the first \$50,000, 1/12% on \$50,001-\$100,000 and 1/24% on the balance. Commission in Lieu of Exchange is 1/8%. Commission on Import Acceptance is 1/8% per month.

Table of Contents

Consideration: An arrangement fee of HK\$20,000. A handling fee in an amount to be mutually agreed upon will be payable annually if the facilities are continuing.

Banking Facilities (Exhibit 4.3)

Date: February 23, 2004

Parties: Fortis Bank Asia HK (Fortis) and Kwanasia

Nature of Contract: Fortis to provide Kwanasia with various general banking facilities.

Terms and Conditions: (1) Import facilities of limit HK\$5,000,000; (2) Overdraft facilities of HK\$2,000,000 with sub-limit of the aforementioned trade limit of HK\$5,000,000; (3) Standby letter of credit issued on Kwanasia's behalf of limit HK\$1,000,000 under sub-limit of the overdraft limit of HK\$2,000,000; (4) Short-term loan facilities of HK\$2,000,000 with sub-limit of the overdraft limit of HK\$2,000,000.

Consideration: The interest and commissions set forth in the agreement dated February 23, 2004. An annual facilities fee of HK\$5,000 per annum.

Revolving Short-term Renminbi Loan Facility (Exhibit 4.4)

Date: November 28, 2002

Parties: UFJ Bank Limited, Shenzhen Branch (UFJ Shenzhen) and Dongguan Kwan Hong Electronics Co. Ltd. (Kwan Hong)

Nature of Contract: UFJ Shenzhen to provide Kwan Hong with short-term revolving RMB loan facility.

Terms and Conditions: Revolving short term Renminbi loan facility of RMB7,000,000 as daily operating funds to Kwan Hong

Consideration: The interest set forth in the agreement dated November 28, 2002.

Revolving Short-term Renminbi Loan Facility (Exhibit 4.5)

Date: May 6, 2003

Parties: Standard Chartered Bank, Shenzhen Branch (Standard Shenzhen) and Kwan Hong

Nature of Contract: Standard Shenzhen to provide Kwan Hong with short-term revolving RMB loan facility to partial finance acquisition of existing factory.

Terms and Conditions: Revolving short-term loan facility of RMB21,000,000. Tenor is up to 1 year. The loan interest is payable monthly in arrears at the interest rate permitted by the People's Bank of China (i.e. 10% below base rate announced by PBOC, currently base rate is 5.04% for tenor up to 6 months and 5.31% for tenor from 6 months up to one year).

Consideration: The bank loan shall be secured by corporate guarantee for HK\$20,000,000 issued by Deswell Industries, Inc.

Tenancy Agreement (Exhibit 4.6)

Date: May 29, 2002

Parties: Shenzhen Shekou Yu Yi Shareholding Company Ltd. (Lessor) and Jetcrown Industrial (Shenzhen) Limited.

Table of Contents

Nature of Contract: Rental of property located at 1/F and 2/F, of Block A, Wing Village Industrial Estate, Shekou, Shenzhen.

Terms and Conditions: The construction area of the property is 2,051 square meters. Three-year term, commencing June 1, 2002 to May 30, 2005. Lessor is responsible for property tax, land use fees and rental housing management fees. A deposit in the amount of RMB118,668 is required. Lessee can only sublet with Lessor's approval. Lessee should inform Lessor of desire to renew lease one month before expiration.

Consideration: Rent is RMB45,094 per month.

Tenancy Agreement (Exhibit 4.7)

Date: May 30, 2003

Parties: Shenzhen Shekou NanShui Enterprises Shareholding (Lessor) and Jetcrown Industrial (Shenzhen) Ltd. (Lessee)

Nature of Contract: Lease of property located at 2/F to 5/F, Block E, Wing Village Industrial Estate, Shekou, Shenzhen.

Terms and Conditions: The construction area of 2/F to 5/F is 4,094 square meters. The rental period is four years, commencing June 1, 2003 to May 31, 2007. Rent for the total property is RMB61,410 per month. The Lessor is responsible to pay for property tax, land use fees and the rental housing management fee of the property. The Lessee is responsible for the water, electricity, cleansing and management charges. A deposit of RMB87,000 is required. Lessee is not allowed to sublet the property without the Lessor's written agreement. Lessee should inform Lessor of its desire to renew the lease one month before expiration and Lessee should be given first priority to renew under the same conditions offered by any third party. The delay charge on Lessee's payment of rent is 3% of the monthly rent multiplied by the number of days the rent is overdue.

Consideration: Rent of RMB61,410 per month.

Tenancy Agreement (Exhibit 4.8)

Date: April 9 and 11, 2001 (Extension is from May 1 2003 to April 30, 2004)

Parties: Shenzhen Shekou East Empire Industrial Co. Ltd. (Lessor) and Jetcrown Industrial (Shenzhen) Limited (Lessee).

Nature of Contract: Lease of property located at 2/F-5/F, Block H, Wing Village Industrial Estate, Shenzhen.

Terms and Conditions: The construction area is 4,120 square meters. The rental period is two years, commencing May 1, 2001 to April 30, 2003 and extended further for one year from May 1, 2003 to April 30, 2004. The total rent for the property is RMB63,860 per month. A deposit of RMB121,540 is required. The Lessor is responsible to pay for the property tax, land use fees and the rental housing management fees. The Lessee is responsible for the water, electricity, cleansing and management charges. The Lessee may not sublease the property without the written approval of the Lessor. Lessee should inform Lessor in writing of its desire to renew the lease three months before the expiration of the lease. Lessee should be given first priority to rent the property under the same terms and conditions as offered by any third party. The delay charge on Lessee's payment of rent is 5% of the monthly rent multiplied by the number of days the rent is overdue.

Consideration: Rent of RMB63,860 per month.

Tenancy Agreement (Exhibit 4.9)

Date: December 31, 2002

Table of Contents

Parties: Shenzhen Shekou Tai Shen Enterprises Shareholding Co. Ltd. (Lessor) and Jetcrown Industrial (Shenzhen) Limited (Lessee).

Nature of Contract: Lease of property located at Block D (five floors total), Wing Village Industrial Estate, Shekou, Shenzhen.

Terms and Conditions: The construction area is 5,442 square meters. The rental period is five years, commencing January 1, 2002 to December 31, 2007. The total rent for the property is HK\$108,840 per month. A deposit of HK\$300,000 is required. The Lessor is responsible to pay for the property tax, land use fees and the rental housing management fees. The Lessee is responsible for the water, electricity, cleansing and management charges. The Lessee may not sublease the property without the written approval of the Lessor. Lessee should inform Lessor in writing of its desire to renew the lease three months before the expiration of the lease. Lessee should be given first priority to rent the property under the same terms and conditions as offered by any third party. The delay charge on Lessee's payment of rent is 3% of the monthly rent multiplied by the number of days the rent is overdue.

Consideration: Rent of HK\$108,840 per month.

Tenancy Agreement (Exhibit 4.10)

Date: January 2, 2003

Parties: Shekou District Yu Yee Shareholding Co. Ltd. (Lessor) and Jetcrown Industrial (Shenzhen) Limited (Lessee).

Nature of Contract: Lease of property located at 1/F to 5/F, Block F, Wing Village Industrial Estate, Shekou, Shenzhen.

Terms and Conditions: The construction area is 5,442 square meters. The rental period is four years, commencing January 1, 2003 to December 31, 2007. The total rent for the property is HK\$108,840 per month. The Lessor is responsible to pay for the property tax, land use fees and the rental housing management fees. The Lessee is responsible for the water, electricity, cleansing and management charges. The Lessee may not sublease the property without the written approval of the Lessor. Lessee should inform Lessor in writing of its desire to renew the lease three months before the expiration of the lease. Lessee should be given first priority to rent the property under the same terms and conditions as offered by any third party. The delay charge on Lessee's payment of rent is 3% of the monthly rent multiplied by the number of days the rent is overdue.

Consideration: Rent of HK\$108,840 per month.

Tenancy Agreement (Exhibit 4.11)

Date: December 31, 2003

Parties: Shenzhen Shekou Real Property Company (Lessor) and Jetcrown Industrial (Shenzhen) Limited (Lessee).

Nature of Contract: Lease of Rooms 201-203, 205-208, 210-214, 305, 307-310, 402-405, 407, 409, 413-414, 416, 502-504, 506-507, 510, 513-516, 601, 603-607, 609-616, 701-716, Block C1, New Wing Village, Shekou for use as a dormitory.

Terms and Conditions: The total construction area for all the rooms is 3,268 square meters. The rental period is one year, commencing January 1, 2004 to December 31, 2004. The total rent for the property is RMB49,027 per month. A

deposit of RMB49,027 is required. The Lessee is responsible for the water, electricity and garbage cleaning charges. If any delay of rental payment exceeds 5 days, a late charge penalty of 2% shall be levied on the rental.

Consideration: Rent of RMB49,027 per month.

Table of Contents

Tenancy Agreement (Exhibit 4.12)

Date: January 7, 2004

Parties: Shenzhen Shekou Real Property Company (Lessor) and Jetcrown Industrial (Shenzhen) Limited (Lessee).

Nature of Contract: Lease of 1/F-7/F, Block 13, Nanshui Siu Village, Room 201-204, 206, 409 of Block 9, NanShui Siu Village and Room 201 and 311 of Block C3 of New Wing Village, Shekou for use as a dormitory.

Terms and Conditions: The total construction area for all the rooms is 2,152 square meters. The rental period is one year, commencing January 1, 2004 to December 31, 2004. The total rent for the property is RMB40,892 per month. A deposit of RMB81,784 is required. The Lessee is responsible for the water, electricity and garbage cleaning charges. If any delay of rental payment, a late charge penalty of 3% shall be levied on the rental.

Consideration: Rent of RMB40,892 per month.

Tenancy Agreement (Exhibit 4.13)

Date: January 1, 2004

Parties: Dongguan Houjie Town Chong Hing Trading Company (Lessor) and Jetcrown Industrial (Dongguan) Limited (Lessee).

Nature of Contract: Lease of a block of industrial building, a block of dormitory, an electricity room at Huangguan Industrial Estate, Ma Tsui, Dongguan.

Terms and Conditions: The total construction area for the factory is 5,224 square meters, dormitory is 2,054 square meters and electricity room is 112 square meters (are in total is 7,390 square meters). The rental period is six months, commencing January 1, 2004 to June 30, 2004. The total rent for the property is RMB62,815 per month. A deposit of RMB200,000 is required. The Lessee is responsible for the water, electricity and garbage cleaning charges. If any delay of rental payment, a late charge penalty of/1000 of the monthly rental shall be levied on the rental.

Consideration: Rent of RMB62,815 per month.

Sale Contract on Land and Factory and Attestation Deed (Exhibit 4.14)

Dates: February 28, 2003 and May 14, 2003, respectively

Parties: Dongguan City Cheung On Town Siu Bin Estate Committee (Transferor) and Dongguan Kwan Hong Electronics Co. Ltd. (Transferee).

Nature of Contract: Sale of Land and factory and dormitory buildings located at the area between Siu Bin Reservoir and Sai Cheong Road, the Second Industrial Zone, Siu Bin Estate, Cheung On Town, Dongguan City for use as factory premises.

Terms and Conditions: The construction area is 22,410 square meters of land and 38,538 square meters of buildings. The period of right of land use is 50 years, from February 1, 2003 to 31 January 2053. The purchase consideration is HK\$650 per square meter for the building premises and HK\$330 per square meter for the land. The total consideration is HK\$32,445,000.

Consideration: Purchase consideration of HK\$32,445,000 in total.

Table of Contents

Taxation

United States Federal Income Tax Consequences

General

This section is a general summary of the material U.S. federal income tax consequences of the ownership and disposition of our common shares as of the date of this Report. The summary applies to you only if you hold our common shares as a capital asset for tax purposes (that is, for investment purposes), and it does not purport to be a comprehensive description of all the tax considerations that may be relevant to the ownership of our common shares. The summary is based on current law. Changes in the law may alter your tax treatment of holding our common shares, possibly on a retroactive basis. There can be no assurance that the U.S. Internal Revenue Service (IRS) will not challenge the tax consequences described below, and we have not requested, nor will we request, a ruling from the IRS or an opinion of counsel with respect to the U.S. federal income tax consequences of acquiring, holding or disposing of our common shares. The discussion below does not cover tax consequences that depend upon your particular tax circumstances and it does not address any aspect of U.S. federal tax law other than U.S. federal income taxation. Specifically, it does not cover any state, local or foreign law, or the possible application of U.S. federal estate or gift tax. You are urged to consult your own tax advisors regarding the application of the U.S. federal income tax laws to your particular situation as well as any state, local, foreign and the U.S. federal estate and gift tax consequences of the ownership and disposition of the common shares. In addition, this summary does not take into account any special U.S. federal income tax rules that apply to a particular holder of our common shares, including, without limitation, the following:

a dealer in securities or currencies;

a trader in securities that elects to use a market-to-market method of accounting for your securities holdings;

a financial institution;

a life insurance company;

a tax-exempt organization;

a person that holds our common shares in a hedging transaction or as part of a straddle or a conversion transaction;

a person whose functional currency for tax purposes is not the U.S. dollar;

a person liable for alternative minimum tax;

a person that owns, or is treated as owning, 10% or more of our common shares; or

a person who receives our shares pursuant to the exercise of employee stock options or otherwise as compensation.

Tax Consequences to U.S. Holders

For purposes of the discussion below, you are a U.S. Holder if you are a beneficial owner of our common shares who or which is:

an individual U.S. citizen or resident alien of the United States (as specifically defined for tax purposes);

a corporation created or organized in or under the laws of the United States or any State or political subdivision thereof;

Table of Contents

an estate whose income is subject to U.S. federal income tax regardless of its source;

a trust (x) if a U.S. court can exercise primary supervision over the trust's administration and one or more U.S. persons are authorized to control all substantial decisions of the trust or (y) if it was in existence on August 20, 1996, was treated as a U.S. person prior to that date and has a valid election in effect under applicable treasury regulations to be treated as a U.S. person; or

any other person or entity that would be subject to U.S. federal income tax on a net income basis in respect of our common shares.

If a partnership holds our common shares, the tax treatment of a partner will generally depend upon the status of the partner and upon the activities of the partnership. If you are a partner of a partnership holding our common shares, you should consult your tax advisor.

Distributions

Subject to the passive foreign investment company rules discussed below, for cash dividends, the gross amount of any such distribution (other than in liquidation) that you receive with respect to our common shares generally will be taxed to you as dividend income to the extent such distribution does not exceed our current or accumulated earnings and profits (E&P), as calculated for U.S. federal income tax purposes. Such income will be includable in your gross income as ordinary income on the date of receipt. Under the tax law enacted in 2003 in the United States, dividends received by individuals in their tax years beginning on January 1, 2003 from qualified foreign corporations are taxed at the rate of 5% (zero, in 2008) or 15%, depending upon the particular taxpayer's U.S. federal income tax bracket; provided that the recipient-shareholder has held his or her shares as a beneficial owner for more than 60 days during the 120-day period beginning on the date which is 60 days before the shares' ex-dividend date. This law sunsets after December 31, 2008, at which time dividends will be taxed at the ordinary income tax rates of up to 35%. A foreign corporation is a qualified foreign corporation with respect to its stock that is traded on an established securities market in the United States, provided that the foreign corporation is not a foreign personal holding company, a foreign investment company or a passive foreign investment company, as defined under the U.S. federal income tax law. Our stock is traded on an established securities market in the United States; we believe that we should not be considered a foreign personal holding company, or a foreign investment company, but we have not made a specific determination as to whether or not we are in fact a passive foreign investment company. In December 2003, the United States Internal Revenue Service issued a statement that for years after 2003, it intends to issue regulations providing procedures for a foreign corporation to certify that it is a qualified foreign corporation, including a certification that it is not a foreign personal holding company, foreign investment company or a passive foreign investment company. At June 30, 2004, no such guidance had been issued. However, if such guidance is issued in the future, we may be unable to certify that we are not a passive foreign investment company. In this case, dividends received from us will be taxed at regular federal income tax rates (up to 35%).

To the extent any distribution exceeds our E&P, the distribution will first be treated as a tax-free return of capital to the extent of your adjusted tax basis in our common shares and will be applied against and reduce such basis on a dollar-for-dollar basis (thereby increasing the amount of gain and decreasing the amount of loss recognized on a subsequent disposition of such shares). To the extent that such distribution exceeds your adjusted tax basis, the distribution will be taxed as gain recognized on a sale or exchange of our common shares. See **Sale or Other Disposition of Our Common Shares**, below. Because we are not a U.S. corporation, no dividends-received deduction will be allowed to corporations with respect to dividends paid by us.

Sale or Other Disposition of Our Common Shares

Subject to the passive foreign investment company rules discussed below, generally, in connection with the sale or other taxable disposition of our common shares:

you will recognize gain or loss equal to the difference (if any) between:

the amount realized on such sale or other taxable disposition and

47

Table of Contents

your adjusted tax basis in such common shares (your adjusted tax basis in the shares you hold generally will equal your U.S. dollar cost of such shares);

such gain or loss will be capital gain or loss and will be long-term capital gain or loss if your holding period for our common shares is more than one year at the time of such sale or other disposition;

under the new tax law described above, net long-term capital gains derived by individual U.S. Holders from sales or other taxable dispositions of our shares after May 5, 2003 and before January 1, 2009, will generally be taxed at the rate of 5% (zero, in 2008) or 15%, depending upon the particular taxpayer's U.S. federal income tax bracket.

such gain or loss will generally be treated as having U.S. source for U.S. foreign tax credit purposes; and

your ability to deduct capital losses is subject to limitations.
Passive Foreign Investment Company

U.S. Holders generally would be subject to a special, adverse tax regime (that would differ in certain material respects from that described above) if we are or were to be classified as a passive foreign investment company (PFIC) for U.S. federal income tax purposes as to our U.S. Holders.

An actual determination of PFIC status is factual in nature and generally cannot be made until the close of the applicable tax year. The Company has not made a specific determination as to whether or not it is in fact a PFIC. We will be a PFIC if either:

75 percent or more of our gross income in a taxable year is passive income (including our pro-rata share of the gross income of any company in which we own, or are treated as owning, 25 percent or more of the shares by value), which includes dividends, interests, royalties, rents, annuities, and some types of gains; or

the average percentage of the value of our assets in a taxable year (including our pro-rata share of the assets of any company in which we own, or are treated as owning, 25 percent or more of the shares by value) that produce or are held for the production of passive income is at least 50 percent.

The application of the above tests could result in our classification as a PFIC even in a year in which we have substantial gross revenues from product sales. If we determine that we are a PFIC, we will endeavor to notify you. If you own common shares during any year in which we are a PFIC, you must file IRS Form 8621.

If we are or were classified as a PFIC during the time you hold our shares, unless you timely make one of specific available elections, a special tax regime would apply to both:

any excess distribution , which would be your share of distributions in any year that are greater than 125 percent of the average annual distributions received by you in the three preceding years before the current taxable year (or during your holding period for the shares, if shorter), and

any gain realized on the sale or other disposition of our common shares.

Under this regime, any excess distribution and realized gain would be treated as ordinary income and would be subject to tax generally in the following manner:

the excess distribution or gain would be allocated ratably to each day that you have held our common shares,

the amount allocated to the taxable year in which you realize the excess distribution or gain would be taxed as ordinary income,

Table of Contents

the amount allocated to the taxable years prior to the first taxable year in which we are a PFIC would be taxed as ordinary income for the taxable year in which you realize the excess distribution or gain, and

the amounts allocated to each of the prior taxable years for which we were a PFIC would be taxed as ordinary income at the highest applicable tax rate in effect for that year, and, in addition, an interest charge generally applicable to underpayments of tax would be imposed on you for the tax deferred.

Subject to certain limitations, if you own common shares in a PFIC that are treated as marketable stock, you may make a mark-to-market election. If you make this election, for all taxable years during which you held common shares and we were a PFIC, you would not be subject to the PFIC rules described above. Instead, in general, you would include as ordinary income each year the excess, if any, of the fair market value of your shares at the end of the taxable year over the adjusted tax basis in your shares. You would also be allowed to take an ordinary loss in respect of the excess, if any, of the adjusted basis of your shares over their fair market value at the end of the taxable year, but only to the extent of the net amount of income previously included as a result of the mark-to-market election. Your basis in the shares would be adjusted to reflect any such income or loss amounts. Any gain realized upon disposition would be taxed as ordinary income. If we are or become a PFIC, we believe our shares would be treated as marketable stock for purposes of the mark-to-market election but we can give you no assurance that they in fact will be so treated.

In lieu of making a mark-to-market election, you may make a qualifying electing fund election. In many situations, it would be desirable to make this election. However, even if your tax advisor determines that this election is beneficial to you, if we are or were to become a PFIC, we may not be able or willing to satisfy the record-keeping and other requirements that would enable you to make a qualified electing fund election.

You are urged to consult your own tax advisor concerning the potential application of the PFIC rules to your ownership and disposition of our common shares.

Tax Consequences to Non-U.S. Holders

If you are not a U.S. Holder, you are a Non-U.S. Holder.

Distributions

You generally will not be subject to U.S. federal income tax, including withholding tax, on distributions made on our common shares unless:

you conduct a trade or business in the United States and

the distributions are effectively connected with the conduct of that trade or business (and, if an applicable income tax treaty so requires as a condition for you to be subject to U.S. federal income tax on a net income basis in respect of income from our common shares, such distributions are attributable to a permanent establishment that you maintain in the United States).

If you meet the two tests above, you generally will be subject to tax in respect of such dividends in the same manner as a U.S. Holder, as described above. In addition, any effectively connected dividends received by a non-U.S. corporation may also, under certain circumstances, be subject to an additional branch profits tax at a 30% rate or such lower rate as may be specified by an applicable income tax treaty.

Sale or Other Disposition of Our Common Shares

Generally, you will not be subject to U.S. federal income tax, including withholding tax, in respect of gain recognized on a sale or other taxable disposition of our common shares unless:

your gain is effectively connected with a trade or business that you conduct in the United States (and, if an applicable income tax treaty so requires as a condition for you to be subject to U.S. federal income tax on a

Table of Contents

net income basis in respect of gain from the sale or other disposition of our common shares, such gain is attributable to a permanent establishment maintained by you in the United States), or

you are an individual Non-U.S. Holder and are present in the United States for at least 183 days in the taxable year of the sale or other disposition, and certain other conditions exist.

You will be subject to tax in respect of any gain effectively connected with your conduct of a trade or business in the United States generally in the same manner as a U.S. holder, as described above. Effectively connected gains realized by a non-U.S. corporation may also, under certain circumstances, be subject to an additional branch profits tax at a rate of 30% or such lower rate as may be specified by an applicable income tax treaty.

Backup Withholding and Information Reporting

Payments (or other taxable distributions) in respect of our common shares that are made in the United States or by a U.S. related financial intermediary will be subject to U.S. information reporting rules. In addition, such payments may be subject to U.S. federal backup withholding at a rate of 28%. You will not be subject to backup withholding provided that:

you are a corporation or other exempt recipient, or

you provide your correct U.S. federal taxpayer identification number and certify that no loss of exemption from backup withholding has occurred.

If you are a Non-U.S. Holder, you generally are not subject to information reporting and backup withholding, but you may be required to provide a certification of your non-U.S. status in order to establish that you are exempt.

Amounts withheld under the backup withholding rules may be credited against your U.S. federal income tax liability, and you may obtain a refund of any excess amounts withheld under the backup withholding rules by filing the appropriate claim for refund with the IRS.

The discussion above is for general information only. It does not cover tax consequences that depend upon your particular tax circumstances. You should consult your own tax advisors regarding the application of the U.S. federal income tax laws to your particular situation as well as any state, local, foreign and the U.S. federal estate and gift tax consequences of the ownership and disposition of the common shares

The discussions above are for general information only. You should consult your own tax advisors regarding the application of the U.S. federal income tax laws to your particular situation as well as any state, local, foreign tax and the U.S. federal estate and gift tax consequences of the ownership and disposition of our common shares and the stock split.

British Virgin Islands Tax Consequences

Under the International Business Companies Act of the British Virgin Islands as currently in effect, a holder of common equity, such as our common shares, who is not a resident of the British Virgin Islands is exempt from British Virgin Islands income tax on dividends paid with respect to the common equity and all holders of common equity are not liable to the British Virgin Islands for income tax on gains realized on sale or disposal of such shares: The British Virgin Islands does not impose a withholding tax on dividends paid by a company incorporated under the International Business Companies Act.

There are no capital gains, gift or inheritance taxes levied by the British Virgin Islands on companies incorporated under the International Business Companies Act. In addition, our common shares are not subject to

transfer taxes, stamp duties or similar charges. There is no income tax treaty or convention currently in effect between the United States and the British Virgin Islands.

Table of Contents**ITEM 11. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK****Exchange Controls**

There are no exchange control restrictions on payments of dividends on the Company's common shares or on the conduct of the Company's operations either in Hong Kong, where the Company's principal executive offices are located, or the British Virgin Islands, where the Company is incorporated. Other jurisdictions in which the Company conducts operations may have various exchange controls. There are no material British Virgin Islands laws which impose foreign exchange controls on the Company or that affect the payment of dividends, interest or other payments to nonresident holders of the Company's common shares. British Virgin Islands law and the Company's Memorandum and Articles of Association impose no limitations on the right of nonresident or foreign owners to hold the Company's Securities or vote the Company's common shares.

China's laws and regulations regulate dividend distribution and repatriation by the Company's China subsidiaries. To date these controls have not had and are not expected to have a material impact on the Company's financial results. To the extent that the Company may decide to pay cash dividends in the future, such dividends will be declared from the retained earnings, i.e., surplus, as determined by resolution of the directors of the Company. As the Company is a holding company, the amount of its retained earnings will be limited by the amount of dividends that can be declared by its subsidiaries. Dividends declared by subsidiaries will be based on the profits reported in their statutory accounts prepared in accordance with generally accepted accounting principles in the relevant countries, primarily Hong Kong and China, which differ from U.S. GAAP. See Note 1 of Notes to Consolidated Financial Statements. Further, the Company intends that portions of the profits earned by Jetcrown Shenzhen will be reinvested and therefore such profits will not be available for the declaration of dividends. See Notes 1 and 8 of Notes to Consolidated Financial Statements.

Foreign Currency Risk

At March 31, 2002, 2003 and 2004 the Company had no open forward exchange contracts or option contracts.

Cash on hand at March 31, 2004 of \$30,583,000 held in the following currencies:

	Equivalent U.S. Dollar Holdings
United States dollars	\$ 17,103,000
Hong Kong dollars	8,382,000
Euro dollar	5,000
Chinese renminbi	3,325,000
Japanese yen	1,746,000
Macao dollars	22,000

See discussion of Exchange Rate Fluctuation in Item 5. Operating and Financial Review and Prospects.

Interest Rate Risk

Our interest expenses and income are sensitive to changes in interest rates, as all of our cash reserves and borrowings are subject to interest rate changes. Cash on hand of \$14,642,000 as at March 31, 2004 was invested in short-term interest bearing investments. As such, interest income will fluctuate with changes in short term interest

rates. As of March 31, 2004 we had no long-term debt or short-term bank loans outstanding on our credit facilities.

ITEM 12. DESCRIPTION OF SECURITIES OTHER THAN EQUITY SECURITIES.

Not applicable.

Table of Contents

PART II

ITEM 13. DEFAULTS, DIVIDEND ARREARAGES AND DELINQUENCIES

Not Applicable.

ITEM 14. MATERIAL MODIFICATIONS TO THE RIGHTS OF SECURITY HOLDERS AND USE OF PROCEEDS

Not Applicable.

ITEM 15. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

As of the end of the Company's fiscal year ended March 31, 2004, we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e) of the Securities Exchange Act of 1934 (the Exchange Act)) pursuant to Rule 13a-15 of the Exchange Act. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that as of the end of the Company's fiscal year ended March 31, 2004, the Company's disclosure controls and procedures are effective in timely alerting them to material information relating to the Company (including its consolidated subsidiaries) required to be included in the reports that the Company files or submits under the Exchange Act.

Changes in Internal Controls

There were no significant changes in the Company's internal controls or in other factors that could significantly affect these controls during the year ended March 31, 2004, nor were there any significant deficiencies or material weaknesses in the Company's internal controls requiring corrective actions.

ITEM 16A. AUDIT COMMITTEE FINANCIAL EXPERT

Deswell's Board of Directors has determined that at least one person serving on the Audit Committee is an audit committee financial expert as defined under Item 16A(b) of Form 20-F. Mr. Allen Yau-Nam Cham is an audit committee financial expert.

ITEM 16B. CODE OF ETHICS

The Company has adopted a Code of Ethics for the Chief Executive Officer and Chief Financial Officer, which applies to the Company's principal executive officer and to its principal financial and accounting officers. A copy of the Code of Ethics is attached as Exhibit 11.1 to this Annual Report on Form 20-F.

ITEM 16C. PRINCIPAL ACCOUNTANT FEES AND SERVICES

Deswell's principal accountants for the audit of its financial statements for each of the two years in the period ended March 31, 2004 was BDO International (BDOI)and BDO McCabe Lo & Co. (BDOMLC).

The following table presents the aggregate fees for professional services and other services rendered by the principal accountant to Deswell in the years ended March 31, 2003 and 2004.

Table of Contents

	Year ended March 31,	
	2003	2004
	(US \$ (in thousands))	
Audit Fees(1)	97	98
Audit-related Fees(2)		
Tax Fees(3)		
All Other Fees(4)	—	—
	97	98

-
- (1) Audit Fees consist of fees billed for the annual audit of our consolidated financial statements and the statutory financial statements of our subsidiaries. They also include fees billed for other audit services, which are those services that only the external auditor reasonably can provide, and include the provision for consents relating to the review of documents filed with the SEC.
- (2) There were no other audit-related fees billed by the principal accountant during the last two fiscal years for assurance and related services that were reasonably related to the performance of the audit not reported under Audit Fees above.
- (3) There were no tax fees billed by the principal accountant during the last two fiscal years.
- (4) There were no other fees billed by the principal accountant during the last two fiscal years for products and services provided by BDO.

Audit Committee Pre-approval Policies and Procedures

The Audit Committee's policy is to pre-approve all audit and permissible non-audit related services provided by the independent auditors. These services may include audit services, audit-related services, tax services and other services. Pre-approval is generally provided for up to one year and any pre-approval is detailed as to the particular service or category of services. The management will periodically report to the Audit Committee regarding the extent of services provided and the fees for the services performed by the independent auditors in accordance with this pre-approval policy. The Audit Committee may also pre-approve particular services on a case-by-case basis.

ITEM 16D. EXEMPTIONS FROM THE LISTING STANDARDS FOR THE AUDIT COMMITTEE.

Not Applicable until the report covering the year ending March 31, 2005.

ITEM 16E. PURCHASES OF EQUITY SECURITIES BY THE ISSUER AND AFFILIATE PURCHASERS.

Not applicable.

PART III

ITEM 17. FINANCIAL STATEMENTS

Not Applicable.

Table of Contents**ITEM 18. FINANCIAL STATEMENTS**

The following financial statements are filed as part of this Report:

	<u>Page No.</u>
Report Of Independent Registered Public Accounting Firm	F-1
Report of Deloitte Touche Tohmatsu	F-2
Consolidated Balance Sheets as of March 31, 2003 and March 31, 2004	F-3
Consolidated Statements of Income for the years ended March 31, 2002, March 31, 2003 and March 31, 2004	F-4
Consolidated Statements of Shareholders' Equity for the years ended March 31, 2002, March 31, 2003 and March 31, 2004	F-5
Consolidated Statements of Cash Flows for the years ended March 31, 2002, March 31, 2003 and March 31, 2004	F-6
Notes to Consolidated Financial Statements	F-7

All other schedules for which provisions are made in the applicable accounting regulations of the Securities and Exchange Commission are not required under the related instructions or are inapplicable, and therefore have been omitted.

Table of Contents

[LETTERHEAD OF BDO MCCABE LO & COMPANY]

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Shareholders and the Board of Directors of
Deswell Industries, Inc.

We have audited the accompanying consolidated balance sheets of Deswell Industries, Inc. and subsidiaries (the Company) as of March 31, 2003 and 2004, and the related consolidated statements of income, shareholders' equity and cash flows for each of the two years in the period ended March 31, 2004. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Deswell Industries, Inc. and subsidiaries as of March 31, 2003 and 2004, and the consolidated results of their operations and their cash flows for each of the two years in the period ended March 31, 2004, in conformity with accounting principles generally accepted in the United States of America.

As discussed in note 2 to the consolidated financial statements, effective April 1, 2002, the Company adopted Statement of Financial Accounting Standards No. 142, Goodwill and Other Intangible Assets.

/s/ BDO McCabe Lo & Company
BDO McCabe Lo & Company

Hong Kong, June 16, 2004

F-1

Table of Contents

{LETTERHEAD OF DELOITTE TOUCHE TOHMATSU}

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Shareholders and the Board of Directors of
Deswell Industries, Inc.

We have audited the accompanying consolidated statements of income, shareholders' equity and cash flows of Deswell Industries, Inc. and its subsidiaries for the year ended March 31, 2002, before the inclusion of the disclosures required by Statement of Financial Accounting Standards No. 142 "Goodwill and Other Intangible Assets" included in Note 2 and the revisions to related per share and number of shares information as a result of the three-for-two stock split described in Note 11. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the results of operations and cash flows of Deswell Industries, Inc. and its subsidiaries for the year ended March 31, 2002 in conformity with accounting principles generally accepted in the United States of America.

/s/ Deloitte Touche Tohmatsu

June 28, 2002
Hong Kong

Table of Contents**DESWELL INDUSTRIES, INC.****CONSOLIDATED BALANCE SHEETS**
(U.S. dollars in thousands)

	March 31,	
	2003	2004
	<hr/>	<hr/>
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 34,400	\$ 30,193
Restricted cash (note 6)	2,366	390
Marketable securities (note 3)	4,821	
Accounts receivable	16,727	18,957
Inventories (note 4)	14,784	16,174
Prepaid expenses and other current assets	2,648	2,952
Income taxes receivable (note 8)	323	127
	<hr/>	<hr/>
Total current assets	76,069	68,793
Property, plant and equipment-net (notes 5 and 6)	29,623	44,261
Other investments	2	2
Goodwill	478	478
	<hr/>	<hr/>
Total assets	\$106,172	\$113,534
	<hr/>	<hr/>
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable	\$ 9,643	\$ 11,168
Accrued payroll and employee benefits	1,312	2,266
Customer deposits	494	759
Other accrued liabilities (note 7)	2,451	1,594
Income taxes payable	3,946	130
	<hr/>	<hr/>
Total current liabilities	17,846	15,917
	<hr/>	<hr/>
Deferred income taxes (note 8)	15	15
	<hr/>	<hr/>
Commitments and contingencies (note 10)		
Minority interests	6,465	7,872
	<hr/>	<hr/>

Shareholders' equity:

Common shares nil par value-authorized 30,000,000 shares,
 shares issued and outstanding March 31, 2003 - 9,030,835;
 March 31, 2004 - 9,149,085 (note 11)

	28,247	29,980
Additional paid-in capital	6,970	6,970
Retained earnings	46,629	52,780
	<u> </u>	<u> </u>
Total shareholders' equity	<u>81,846</u>	<u>89,730</u>
Total liabilities and shareholders' equity	<u>\$106,172</u>	<u>\$113,534</u>

See accompanying notes to consolidated financial statements.

F-3

Table of Contents**DESWELL INDUSTRIES, INC.****CONSOLIDATED STATEMENTS OF INCOME**
(U.S. dollars in thousands, except per share data)

	Year ended March 31,		
	2002	2003	2004
Net sales	\$83,320	\$90,905	\$97,195
Cost of sales	<u>54,448</u>	<u>61,006</u>	<u>66,105</u>
Gross profit	28,872	29,899	31,090
Selling, general and administrative expenses	<u>14,939</u>	<u>15,354</u>	<u>14,718</u>
Operating income	13,933	14,545	16,372
Interest expense	(26)	(6)	(16)
Other income, net	<u>877</u>	<u>818</u>	<u>910</u>
Income before income taxes and minority interests	14,784	15,357	17,266
Income taxes (note 8)	<u>535</u>	<u>3,826</u>	<u>589</u>
Income before minority interests	14,249	11,531	16,677
Minority interests	<u>925</u>	<u>1,288</u>	<u>1,957</u>
Net income	<u>\$13,324</u>	<u>\$10,243</u>	<u>\$14,720</u>
Net income per share (note 2)			
Basic:			
Net income per share	<u>\$ 1.59</u>	<u>\$ 1.18</u>	<u>\$ 1.62</u>
Weighted average common shares outstanding	<u>8,403</u>	<u>8,672</u>	<u>9,109</u>
Diluted:			
Net income per share	<u>\$ 1.57</u>	<u>\$ 1.16</u>	<u>\$ 1.56</u>
	8,466	8,852	9,440

Weighted average common and potential common
shares

See accompanying notes to consolidated financial statements.

F-4

Table of Contents**DESWELL INDUSTRIES, INC.****CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY**
(U.S. dollars in thousands, except share and per share data)

	Common stock		Additional paid-in capital	Retained earnings	Shareholders equity
	Shares outstanding	Amount			
Balance at March 31, 2001	8,396,896	19,929	6,970	36,978	63,877
Exercise of stock options	24,750	243			243
Repurchase and cancellation of common stock	(51,150)	(564)			(564)
Net income				13,324	13,324
Dividends (\$0.86 per share)				(7,229)	(7,229)
	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>
Balance at March 31, 2002	8,370,496	19,608	6,970	43,073	69,651
Exercise of stock options	408,500	4,217			4,217
Odd share redemption upon stock split	(41)	(1)			(1)
Issuance of common stock for acquisition of additional 20% interest in a subsidiary	251,880	4,423			4,423
Net income				10,243	10,243
Dividends (\$0.77 per share)				(6,687)	(6,687)
	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>
Balance at March 31, 2003	9,030,835	28,247	6,970	46,629	81,846
Exercise of stock options	118,250	1,733			1,733
Net income				14,720	14,720
Dividends (\$0.94 per share)				(8,569)	(8,569)
	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>
Balance at March 31, 2004	<u>9,149,085</u>	<u>29,980</u>	<u>6,970</u>	<u>52,780</u>	<u>89,730</u>

See accompanying notes to consolidated financial statements.

Table of Contents**DESWELL INDUSTRIES, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS**
(U.S. dollars in thousands)

	Year ended March 31,		
	2002	2003	2004
Cash flows from operating activities			
Net income	\$ 13,324	\$ 10,243	\$ 14,720
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	4,918	4,692	4,402
Loss (gain) on sale of property, plant and equipment	7	6	392
Net realized (gain) and unrealized holding (gain) loss on marketable securities	(119)	355	(533)
Minority interests	925	1,288	1,901
Changes in operating assets and liabilities:			
Accounts receivable	(1,111)	161	(2,230)
Inventories	(1,191)	(1,559)	(1,390)
Prepaid expenses and other current assets	(1,588)	773	(304)
Income taxes receivable		105	196
Accounts payable	3,309	2,060	1,525
Accrued payroll and employee benefits	40	(565)	954
Customer deposits	844	(2,200)	265
Other accrued liabilities	(27)	702	(857)
Income taxes payable	(132)	3,781	(3,816)
	<u>19,199</u>	<u>19,842</u>	<u>15,225</u>
Net cash provided by operating activities			
Cash flows from investing activities			
Purchase of property, plant and equipment	(4,397)	(9,731)	(19,862)
Proceeds from sale of property, plant and equipment	276	127	430
Acquisition of marketable securities	(1,574)	(4,061)	(1,056)
Proceeds from sale of marketable securities	578		6,410
Acquisition of other investments		(2)	
	<u>(5,117)</u>	<u>(13,667)</u>	<u>(14,078)</u>
Net cash used in investing activities			
Cash flows from financing activities			
Dividends paid	(7,229)	(6,687)	(8,569)
Dividends paid to minority shareholders of a subsidiary		(851)	(582)

Edgar Filing: DESWELL INDUSTRIES INC - Form 20-F

Repurchase of common stock	(564)		
Increase (decrease) in bank loans	482	(482)	
Exercise of stock options	243	4,217	1,733
Odd shares redemption		(1)	
(Increase) decrease in restricted cash	(873)	495	1,976
Contribution from minority shareholders of subsidiaries	63		88
	<u> </u>	<u> </u>	<u> </u>
Net cash used in financing activities	(7,878)	(3,309)	(5,354)
	<u> </u>	<u> </u>	<u> </u>
Net (decrease) increase in cash and cash equivalents	6,204	2,866	(4,207)
Cash and cash equivalents, beginning of year	25,330	31,534	34,400
	<u> </u>	<u> </u>	<u> </u>
Cash and cash equivalents, end of year	\$31,534	\$ 34,400	\$ 30,193
	<u> </u>	<u> </u>	<u> </u>
Supplementary disclosures of cash flow information:			
Cash paid (refunded) during the year for:			
Interest	\$ 26	\$ 6	\$ 16
Income taxes	\$ 669	\$ (60)	\$ 4,210
	<u> </u>	<u> </u>	<u> </u>
Supplementary disclosures of significant non-cash transactions:			
Issuance of common stock in connection with acquisition of additional 20% shareholding in a subsidiary	\$	\$ 4,423	\$
	<u> </u>	<u> </u>	<u> </u>

See accompanying notes to consolidated financial statements.

Table of Contents

DESWELL INDUSTRIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(U.S. dollars in thousands, except share data)

1. Organization and Basis of Financial Statements

Deswell Industries, Inc. was incorporated in the British Virgin Islands on December 2, 1993.

The principal activities of the Company comprise the manufacture and sale of injection-molded plastic parts and components, electronic products assembling and metallic parts manufacturing. The selling and administrative activities were performed in the Hong Kong Special Administrative Region (Hong Kong) of the People s Republic of China (China). From August 2003, these activities have been moved to the Macau Special Administrative Region (Macau) of China. The manufacturing activities are subcontracted to subsidiaries operating in Mainland China.

As the Company is a holding company, the amount of any dividends declared by the Company will be dependent upon the amount which can be dividended up from its subsidiaries. Dividends from subsidiaries will be declared based on profits as reported in their statutory accounts. Such profits will differ from the amounts reported under U.S. GAAP. At March 31, 2004, the retained earnings available for distribution as reflected in the statutory books of the subsidiaries were \$43,122 of which \$1,637 relates to a subsidiary in China, certain of whose retained earnings are intended to be reinvested rather than used to fund dividends in order to obtain favorable tax concessions (note 8).

On January 20, 2003, the Company acquired a further 20% of the outstanding stock of Integrated International Limited (Integrated), a subsidiary of the Company, from the minority shareholders. After the acquisition, the Company increased its ownership in Integrated to 71% of the outstanding stock. The purchase consideration for the 20% of the outstanding stock of Integrated is 251,880 common shares of the Company. The value of the purchase consideration is based on the market price of the stocks issued which is lower than the fair value of net assets acquired by \$115. The excess has been allocated as a pro rata reduction of the amounts that would have been assigned to certain acquired assets.

2. Summary of Significant Accounting Policies

Principles of consolidation-The consolidated financial statements, prepared in accordance with generally accepted accounting principles in the United States of America, include the assets, liabilities, revenues, expenses and cash flows of all subsidiaries. Intercompany balances, transactions and cash flows are eliminated on consolidation.

Goodwill-The excess purchase price over the fair value of net assets acquired is recorded on the balance sheet as goodwill. Prior to April 1, 2002, goodwill was amortized to expense on a straight line basis over 20 years. On April 1, 2002, the Company adopted Statement of Financial Accounting Standards (SFAS) No. 142 Goodwill and other Intangible Assets , which established new standards for goodwill acquired in a business combination, eliminates the amortization of goodwill and requires the carrying value of goodwill to be evaluated for impairment on an annual basis.

Had goodwill amortization been discontinued effective April 1, 2001, net income for the financial year ended March 31, 2002 would have been increased by \$35 to \$13,359. After adjusting for the impact of discontinued goodwill amortization, net income per common share for the financial years ended March 31, 2002 would remain the same, and diluted net income per share for the year ended March 31, 2002 would have been higher by \$0.01.

In accordance with SFAS No. 142, goodwill is evaluated to determine if fair value of the asset has decreased below its carrying value. At March 31, 2004, the Company completed its annual impairment evaluation and determined that

there was no impairment in goodwill.

Cash and cash equivalents-Cash and cash equivalents include cash on hand, cash accounts, interest bearing savings accounts and time certificates of deposit with a maturity of three months or less when purchased.

Marketable securities-All marketable securities are classified as trading securities and are stated at fair market value. Market value is determined by the most recently traded price of the security at the balance sheet date. Net realized and unrealized gains and losses on trading securities are included in other income. The cost of investments sold is based on the average cost method and interest earned is included in other income.

Inventories-Inventories are stated at the lower of cost, determined by the first-in, first-out method, or market. Work-in-progress and finished goods inventories consist of raw materials, direct labour and overhead associated with the manufacturing process.

Prepaid expenses and other current assets-Prepaid expenses and other current assets consist principally of rental deposits, prepaid expenses and other miscellaneous receivables.

Table of Contents**2. Summary of Significant Accounting Policies - continued**

Property, plant and equipment-Property, plant and equipment is stated at cost including the cost of improvements. Maintenance and repairs are charged to expense as incurred. Depreciation and amortization are provided on the straight line method based on the estimated useful lives of the assets as follows:

Leasehold land and buildings	40 - 50 years
Plant and machinery	4 - 10 years
Furniture, fixtures and equipment	4 - 5 years
Motor vehicles	3 - 4 years
Leasehold improvements the lease term	the shorter of 5 years or

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.

Revenue recognition-The Company recognizes revenue at the time the title is passed to customers upon shipment and when collectibility is reasonably assured.

Comprehensive income-The comprehensive income of the Company for the years ended March 31, 2002, 2003 and 2004 was represented by the net income of the respective years.

Shipping and handling cost-Shipping and handling costs related to the delivery of finished goods are included in selling expenses. During the year ended March 31, 2002, 2003 and 2004, shipping and handling costs expensed to selling expenses were \$638, \$653 and \$989, respectively.

Income taxes-Income taxes are provided on an asset and liability approach for financial accounting and reporting of income taxes. Any China tax paid by subsidiaries during the year is recorded as an amount receivable at year end when an application for reinvestment of profits has been filed and a refund is expected unless there is an indication from the China tax authority that the refund will be refused. Deferred income tax liabilities or assets are recorded to reflect the tax consequences in future years of differences between the tax basis of assets and liabilities and the financial reporting amounts at each year end. A valuation allowance is recognized if it is more likely than not that some portion, or all, of a deferred tax asset will not be realized.

Foreign currency translation-The consolidated financial statements of the Company are presented in U.S. dollars as the Company is incorporated in the British Virgin Islands where the currency is the U.S. dollar. The Company's subsidiaries conduct substantially all of their business in Hong Kong dollars, the exchange rate of which has been fixed to the U.S. dollar at approximately HK\$7.80 to \$1.00 since 1983. There is, however, no assurance that this rate will continue indefinitely.

All transactions in currencies other than functional currencies during the year are translated at the exchange rates prevailing on the transaction dates. Related accounts payable or receivable existing at the balance sheet date denominated in currencies other than the functional currencies are translated at period end rates. Gains and losses resulting from the translation of foreign currency transactions and balances are included in income.

Aggregate net foreign currency transaction gains (losses) included in income were \$(306), \$503 and \$(52) for the years ended March 31, 2002, 2003 and 2004, respectively.

On consolidation, the financial statements of subsidiaries are translated from Hong Kong dollars, being the functional currency of all of the Company's subsidiaries, into U.S. dollars in accordance with SFAS No. 52, Foreign Currency Translation. Accordingly all assets and liabilities are translated at the exchange rates prevailing at the balance sheet dates and all income and expenditure items are translated at the average rates for each of the years. The exchange rate between the Hong Kong dollar and the U.S. dollar used for the years ended March 31, 2002, 2003 and 2004 were HK\$7.75 to US\$1.00.

Post-retirement and post-employment benefits-The Company and its subsidiaries contribute to a state pension scheme in respect of its PRC employees and a mandatory provident fund scheme in respect of its Hong Kong employees. Neither the Company nor its subsidiaries provide any other post-retirement or post-employment benefits.

Stock-based compensation-SFAS No. 123 Accounting for Stock-Based Compensation allows companies which have stock-based awards to employees to adopt a new fair value basis of accounting for stock options and other equity instruments or to continue to apply the existing accounting rules under Accounting Principles Board (APB) No. 25, Accounting for Stock Issued to Employees, but with additional financial statement disclosure.

Table of Contents**2. Summary of Significant Accounting Policies - continued**

The Company accounts for its stock-based awards to employees using the intrinsic value method in accordance with APB No. 25, SFAS No. 123 requires the disclosure of pro forma net income and net income per share as if the Company had adopted the fair value method, as follows:

	<u>2002</u>	<u>2003</u>	<u>2004</u>
Net income:			
As reported	\$ 13,324	\$ 10,243	\$ 14,720
Pro forma	<u>11,775</u>	<u>10,243</u>	<u>11,525</u>
Stock-based employee compensation cost, net of tax	\$ 1,549	\$	\$ 3,195
Basic net income per share:			
As reported	\$ 1.59	\$ 1.18	\$ 1.62
Pro forma	1.40	1.18	1.27
Diluted net income per share:			
As reported	\$ 1.57	\$ 1.16	\$ 1.56
Pro forma	1.39	1.16	1.22

The fair value of options granted in the years ended March 31, 2002 and 2004 was estimated to be approximately \$1.93 and \$5.33 per share respectively using the Black-Scholes option pricing model with the following assumptions:

	<u>2002</u>	<u>2003</u>	<u>2004</u>
Risk-free interest rate - weighted average	5.42%	n/a	3.93%
Expected life of options - weighted average	10 years	n/a	10 years
Expected volatility	32%	n/a	34.78%
Expected dividend yield	7.57%	n/a	4.60%

Net income per share-Basic net income per share is computed by dividing net income available to common shareholders by the weighted average number of common shares outstanding during the period. Diluted net income per share gives effect to all dilutive potential common shares outstanding during the period. The weighted average number of common shares outstanding is adjusted to include the number of additional common shares that would have been outstanding if the dilutive potential common shares had been issued. In computing the dilutive effect of potential common shares, the average stock price for the period is used in determining the number of treasury shares assumed to be purchased with the proceeds from the exercise of options.

Basic net income per share and diluted net income per share calculated in accordance with SFAS No. 128, Earnings Per Share, are reconciled as follows (shares in thousands):

	<u>Year ended March 31,</u>		
	<u>2002</u>	<u>2003</u>	<u>2004</u>
Net income	<u>\$ 13,324</u>	<u>\$ 10,243</u>	<u>\$ 14,720</u>

Basic net income per share	\$ 1.59	\$ 1.18	\$ 1.62
	<u> </u>	<u> </u>	<u> </u>
Basic weighted average common shares outstanding	8,403	8,672	9,109
Effect of dilutive securities - Options	63	180	331
	<u> </u>	<u> </u>	<u> </u>
Diluted weighted average common and potential common shares outstanding	8,466	8,852	9,440
	<u> </u>	<u> </u>	<u> </u>
Diluted net income per share	\$ 1.57	\$ 1.16	\$ 1.56
	<u> </u>	<u> </u>	<u> </u>

Use of estimates- The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Table of Contents**2. Summary of Significant Accounting Policies - continued**

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 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 not expect the adoption of this statement to have a material impact on the Company's financial position or results of operations.

3. Marketable Securities

The Company acquired equity securities listed in Hong Kong.

	March 31,	
	2003	2004
Cost	\$5,176	\$

Market value	\$4,821	\$
--------------	---------	----

Unrealized gain (loss) for the years ended March 31, 2002, 2003 and 2004 were \$34, \$(355) and \$nil, respectively.

Net proceeds from sale of marketable securities for the year ended March 31, 2002, 2003 and 2004 were \$578, \$nil and \$6,411, and realized gains from sale of marketable securities for the year ended March 31, 2002, 2003 and 2004 were \$85, \$nil and \$533, respectively. For the purposes of determining realized gains and losses, the cost of securities sold was determined based on the average cost method.

Table of Contents**4. Inventories**

Inventories by major categories are summarized as follows:

	March 31,	
	2003	2004
Raw materials	\$ 7,432	\$ 7,832
Work in progress	4,454	4,467
Finished goods	2,898	3,875
	<u> </u>	<u> </u>
	\$14,784	\$16,174
	<u> </u>	<u> </u>

5. Property, Plant and Equipment

Property, plant and equipment consists of the following:

	March 31,	
	2003	2004
At cost:		
Land and buildings	\$ 4,957	\$ 18,178
Plant and machinery	22,160	25,097
Furniture, fixtures and equipment	11,332	13,515
Motor vehicles	2,577	2,213
Leasehold improvements	3,942	4,615
	<u> </u>	<u> </u>
Total	44,968	63,618
Less: accumulated depreciation and amortization	(26,943)	(25,702)
Construction in progress	11,598	6,345
	<u> </u>	<u> </u>
Net book value	\$ 29,623	\$ 44,261
	<u> </u>	<u> </u>
Cost of land and buildings consist of the following:		
Leasehold land and buildings (a)	\$ 2,122	\$ 1,482
Land use right of state-owned land and buildings erected thereon (b)	9	9,684
Long term leased land and buildings erected thereon (c)		4,186
Other buildings (d)	2,826	2,826
	<u> </u>	<u> </u>
	\$ 4,957	\$ 18,178
	<u> </u>	<u> </u>

(a) Leasehold land and buildings are located in Hong Kong with lease terms of 50 years expiring in 2047.

(b) The land use rights of state-owned land and buildings erected thereon represent land and buildings located in China with lease terms of 50 years expiring in 2050.

(c) Long term leased land and buildings erected thereon represent land and buildings on collectively-owned land located in China on which an upfront lump-sum payment has been made for the right to use the land and building for a term of 50 years to 2053. Dongguan Cheng An Xiaobian District Co-operation is the entity to whom the collectively-owned land has been granted. According to existing China laws and regulations, collectively-owned land is not freely transferable unless certain application and approval procedures are fulfilled by the Dongguan Cheng An Xiaobian District Co-operation to change the legal form of the land from collectively-owned to state-owned. As of March 31, 2004, the Company is not aware in respect of any steps taken by the Dongguan Cheng An Xiaobian District Co-operation for such application.

(d) Other buildings represent factory premises and dormitory units located in China purchased by the Company with lease terms from 30 to 70 years expiring from 2018 to 2063.

6. Credit facilities and pledged assets

The Company has credit lines with various banks representing trade acceptances, loans and overdrafts. At March 31, 2003 and 2004 these facilities totalled \$20,839, and \$10,118, respectively. The maturities of these facilities are generally up to 90 days. Interest rates are generally based on the banks' prime lending rates and the credit lines are normally subject to annual review. There are no significant covenants or other financial restrictions relating to the Company's facilities except that at March 31, 2003 and 2004, cash of \$2,366 and \$390, respectively, and leasehold land and buildings of net book value \$1,318 and \$1,288, respectively, have been pledged as collaterals for the above facilities. As of March 31, 2003 and 2004, the Company has not borrowed against these lines.

Table of Contents**7. Other Accrued liabilities**

Other accrued liabilities consist of the following:

	March 31,	
	2003	2004
Value added tax payable	\$ 695	\$ 306
Accrued expenses	235	419
Provision for tax risks	801	
Commission expenses	109	57
Others	611	812
	<u>2,451</u>	<u>1,594</u>

8. Income Taxes

The components of income before income taxes and minority interests are as follows:

	Year ended March 31,		
	2002	2003	2004
Hong Kong	\$ 1,245	\$ 5	\$ 216
China and others	13,539	15,352	17,050
	<u>14,784</u>	<u>15,357</u>	<u>17,266</u>

Hong Kong

The Company is subject to Hong Kong taxation on its activities conducted in Hong Kong. Each company in Hong Kong files a separate tax return and is subject to tax on its taxable income arising in or derived from Hong Kong.

China

Enterprise income tax in China is generally charged at 33%, in which 30% is for national tax and 3% is for local tax, of the assessable profit. For foreign investment enterprises established in a Special Economic Zone or Coastal Open Economic Zone, where the subsidiaries of the Company are located, and which are engaged in production-oriented activities, the national tax rate could be reduced to 15% and 24% respectively. The Company's subsidiaries incorporated in China are subject to China income taxes at the applicable tax rates on the taxable income as reported in their Chinese statutory accounts in accordance with the relevant income tax laws applicable to foreign enterprises. Pursuant to the same income tax laws, the subsidiaries are fully exempted from China income tax for two years starting from the first profit-making year, followed by a 50% tax exemption for the next three years.

Jetcrown Industrial (Shenzhen) Limited (Jetcrown Shenzhen) (a subsidiary of the Company) had fully enjoyed the above tax holiday and concessions by December 31, 1995. Afterwards, Jetcrown Shenzhen has been approved as an Export-oriented Enterprise by the local tax authority and enjoyed a lower tax rate of 10% for the calendar years ended December 31, 2001, 2002 and 2003.

Dongguan Kwan Hong Electronics Company Limited (Dongguan Kwan Hong) (a subsidiary of the Company) has been approved as a High-tech Enterprise by the local tax authority and enjoyed a lower tax rate of 15%. Dongguan Kwan Hong has its first tax exemption year in the calendar year ended December 31, 2000 and enjoyed the 50% tax exemption for the calendar years ended December 2002 and 2003.

Jetcrown Industrial (Dongguan) Limited (a subsidiary of the Company) has not commenced its first tax exemption year for the years ended March 31, 2002, 2003 and 2004.

Pursuant to a further concession in the income tax laws, the Company, as a foreign shareholder in a foreign enterprise in China, is eligible for a refund of taxes paid by its Chinese subsidiaries on the proportion of the after-tax profits of these subsidiaries which are reinvested by the Company in these subsidiaries or in other foreign enterprises in China provided that the reinvestment period relating to such subsidiaries or other foreign enterprises is for at least five years from the date the reinvested funds are contributed. If the reinvestment period is less than five years, the income tax refunded will be repayable to the Chinese tax authorities.

During the years ended March 31, 2002, 2003 and 2004, the Company recorded a benefit relating to its decision to reinvest earnings of its Chinese subsidiary, Jetcrown Shenzhen, totaling \$nil, \$323 and \$nil, respectively.

Table of Contents**8. Income Taxes- continued**

Had the all above tax holidays and concessions not been available, the tax charge would have been higher by \$272, \$611 and \$1,811 and the basic net income per share would have been lower by \$0.03, \$0.07 and \$0.18 for the years ended March 31, 2002, 2003 and 2004 respectively, and diluted net income per share for the years ended March 31, 2002, 2003 and 2004 would have been lower by \$0.03, \$0.07 and \$0.17, respectively.

Others

Certain of the Company's income accrues in tax free jurisdictions and is not subject to any income taxes.

The provision for income taxes consists of the following:

	Year ended March 31,		
	2002	2003	2004
Current tax			
- Hong Kong	\$251	\$3,674	\$132
- China	284	152	457
Deferred tax	—	—	—
	\$535	\$3,826	\$589

A reconciliation between the provision for income taxes computed by applying the statutory tax rate in Hong Kong or China to income before income taxes and the actual provision for income taxes is as follows:

	Year ended March 31,		
	2002	2003	2004
Provision for income taxes at statutory tax rate in - Hong Kong	2,365	2,457	
- China			4,661
Effect of different tax rate in various jurisdictions	(207)	(238)	(210)
Tax holidays and concessions	443	(733)	(1,811)
Effect of income for which no income tax is payable	(2,150)	(1,047)	(1,977)
Increase (decrease) in valuation allowances	46	(310)	
Under (over) provision of income tax in previous year	9	78	(22)
Additional assessments for previous years (a)		3,532	
Others	29	87	(52)
	535	3,826	589
Effective tax			

(a) The Company has made a settlement with Hong Kong Inland Revenue Department (IRD) regarding a disagreement on whether taxes should be assessed 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 profits tax under the Hong Kong Revenue Ordinance. While, based on consultations with Hong Kong tax experts, management 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 make a proposal for settlement with the IRD in order to avoid the expenditure of substantial time, effort and expense involved in proceedings that could extend years. An amount of \$3,532 has been charged to the consolidated income statement for the year ended March 31, 2003.

The components of deferred income tax are as follows:

	March 31,	
	2003	2004
Deferred tax asset:		
Net operating loss carryforwards	\$	\$
Less: Valuation allowances	—	—
	—	—
Deferred tax liability:		
Property, plant and equipment	(15)	(15)
	—	—
Net deferred tax liability	\$(15)	\$(15)

9. Related Party Transactions

During the year ended March 31, 2002, the Company rented employee accommodation in China from Mr. S.K. Lee and Mr. M.C. Tam, both are executive officers of the Company and minority shareholders of Kwanasia, a subsidiary of the Company. Rentals charged by them to the Company were \$12 for the year ended March 31, 2002. No such rental arrangement was made in the years ended March 31, 2003 and March 31, 2004.

Table of Contents**10. Commitments and Contingencies**

The Company leases premises under various operating leases, certain of which contain escalation clauses. Rental expenses under operating leases included in the statement of income were \$2,169, \$1,917 and \$1,507 for the years ended March 31, 2002, 2003 and 2004, respectively.

At March 31, 2004, the Company was obligated under operating leases requiring minimum rentals as follows:

Years ending March 31 2005	\$ 915
2006	600
2007	450
2008	272

Total minimum lease payments	\$2,237

At March 31, 2004, the Company had capital commitments for plant and machinery totalling \$758 which is expected to be disbursed during the year ending March 31, 2005.

The Company has contracted with some building contractors to construct the Company's new factory plant in Dongguan, the PRC. The budgeted costs of the whole project are estimated to be \$20,242. At March 31, 2004, a total of \$18,552 has been paid on the project and are recorded in property, plant and equipment.

11. Shareholders' Equity

On July 8, 2002, the Company completed a three-for-two stock split. In conjunction with this stock split, the authorized share capital has been increased from 20,000,000 to 30,000,000 common shares. The par value of common stock has been changed to nil at the same time. No fractional shares were issued and 41 shares were redeemed and cancelled upon the stock split. All financial statements have been retroactively restated to account for the change.

12. Employee Benefits

The Company contributes to a state pension scheme run by the Chinese government in respect of its employees in China. The expense related to this plan, which is calculated at 16% of the average monthly salary, was \$281, \$260 and \$272 for the years ended March 31, 2002, 2003 and 2004, respectively. In December 1996, the Company established a defined contribution plan for certain of the employees in Hong Kong. The plan provides for annual contributions by the Company at the rate of 5% of eligible compensation of employees based on length of service and requires contribution by employees at the rate of 5% of eligible compensation. The plan ceased on November 30, 2000. According to the Mandatory Provident Fund (MPF) legislation regulated by the Mandatory Provident Fund Schemes Authority in Hong Kong, with effect from December 1, 2000, the Company is required to participate in a MPF scheme operated by approved trustees in Hong Kong and to make contributions for its eligible employees. The contributions borne by the Company are calculated at 5% of the salaries and wages (monthly contribution is limited to 5% of HK\$20 for each eligible employee) as calculated under the MPF legislation. The expense related to the MPF in the years ended March 31, 2002, 2003 and 2004 amounted to \$66, \$63 and \$31, respectively.

13. Stock Option Plan

On March 15, 1995, the Company adopted 1995 Stock Option Plan that permits the Company to grant options to officers, directors, employees and others to purchase up to 675,000 shares of Common Stock. On September 29, 1998, the Company approved an increase of 366,000 shares making a total of 1,041,000 shares of common stock available

under the stock option plan. On January 7, 2002, the Company adopted 2001 Stock Option Plan to purchase an additional 750,000 shares of Common Stock. On September 30, 2003, the Company adopted 2003 Stock Option Plan to purchase an additional 600,000 shares of Common Stock. At March 31, 2004, options to purchase an aggregate of 2,391,000 common shares had been granted under the stock option plans. Options granted under the stock option plans will be exercisable for a period of up to 10 years commencing on the date of grant, at a price equal to at least the fair market value of the Common Stock at the date of grant, and may contain such other terms as the Board of Directors or a committee appointed to administer the plan may determine. A summary of the option activity (with weighted average prices per share) is as follows:

F-14

Table of Contents**13. Stock Option Plan - Continued**

	2002		Year ended March 31, 2003		2004	
	Number of stock options	Weighted average exercise price	Number of stock options	Weighted average exercise price	Number of stock options	Weighted average exercise price
Outstanding at beginning of the year	300,000	\$ 9.83	1,076,250	\$ 10.95	667,750	\$11.33
Granted during the year	801,000	11.33			600,000	21.15
Exercised during the year	(24,750)	9.83	(408,500)	10.32	(118,250)	14.65
Outstanding and exercisable at the end of the year	<u>1,076,250</u>	<u>10.95</u>	<u>667,750</u>	<u>11.33</u>	<u>1,149,500</u>	<u>16.11</u>
Range of exercise price per share		\$9.83 to \$11.33		\$ 11.33		\$11.33 to \$21.15

The weighted average remaining contractual life of the share options outstanding at March 31, 2004 was 8.62 years. At March 31, 2003 and 2004, there were nil options available for future grant under the plans respectively.

14. Operating Risk

Concentrations of Credit Risk and Major Customers-A substantial percentage of the Company's sales are made to a small number of customers and are typically sold either under letter of credit or on an open account basis. Details of customers accounting for 10% or more of total net sales for each of the three years ended March 31, 2002, 2003 and 2004 are as follows:

	Percentage of net sales Year ended March 31,		
	2002	2003	2004
Digidesign, Inc.	*	13.5%	17.8%
VTech Telecommunications Limited	15.3%	11.6%	17.6%
Epson Precision (H.K.) Limited	17.5%	22.3%	15.4%
Inter-Tel Incorporated	11.6%	13.0%	10.3%
Kyocera Mita Industrial Co. (H.K.) Limited	13.6%	10.9%	*

* Less than 10%

Sales to the above customers relate to both injection-molded plastic parts and electronic products.

Details of the amounts receivable from the five customers with the largest receivable balances at March 31, 2003 and 2004, respectively, are as follows:

	Percentage of accounts receivable March 31,	
	2003	2004
Largest receivable balances	65.5%	58.3%

The Company has not experienced any significant difficulty in collecting its accounts receivable in the past and is not aware of any financial difficulties being experienced by its major customers. There has been no significant bad debt expense during each of the three years ended March 31, 2002, 2003 and 2004 and there was no provision for bad debts at the beginning and end of the three years ended March 31, 2002, 2003 and 2004.

Country risk-The Company has significant investments in China. The operating results of the Company may be adversely affected by changes in the political and social conditions in China, and by changes in Chinese government policies with respect to laws and regulations, anti-inflationary measures, currency conversion and remittance abroad, and rates and methods taxation, among other things. There can be no assurance, however, those changes in political and other conditions will not result in any adverse impact.

Table of Contents**15. Fair Value of Financial Instruments**

The carrying amounts of cash and cash equivalents, restricted cash, marketable securities, accounts receivable, accounts payable and are reasonable estimates of their fair value. All the financial instruments are for trade purposes.

16. Segment Information

The Company has three reportable segments: plastic injection molding, electronic products assembling and metallic parts manufacturing. The Company's reportable segments are strategic business units that offer different products and services. They are managed separately because each business requires different technology and marketing strategies. Most of the businesses were acquired as a unit, and the management at the time of the acquisition was retained.

The accounting policies of the segments are the same as those described in the summary of significant accounting policies. The Company accounts for intersegment sales and transfers as if the sales or transfers were to third parties, that is, at current market prices.

Contributions of the major activities, profitability information and asset information of the Company's reportable segments for the years ended March 31, 2002, 2003 and 2004 are as follows:

	Year ended March 31,					
	2002			2003		
	Net sales	Intersegment sales	Profit (loss)	Net sales	Intersegment sales	Profit (loss)
Segment:						
Injection molded plastic parts	\$47,504	\$	\$13,010	\$50,975	\$ 1,068	\$12,687
Electronic products	33,672	15	2,067	38,221	8	3,313
Metallic parts	4,987	2,828	(258)	5,542	2,757	(643)
	<u> </u>	<u> </u>	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Segment total	\$86,163	\$ 2,843	\$14,819	\$94,738	\$ 3,833	\$15,357
Reconciliation to consolidated totals:						
Sales eliminations	(2,843)	(2,843)		(3,833)	(3,833)	
Goodwill amortization not allocated to segment			(35)			
	<u> </u>	<u> </u>	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Consolidated totals:						
Net sales	\$83,320	\$		\$90,905	\$	
	<u> </u>	<u> </u>		<u> </u>	<u> </u>	
Income before income taxes and minority interests			\$14,784			\$15,357

[Additional columns below]

[Continued from above table, first column(s) repeated]

	Year ended March 31,		
	2004		
	Net sales	Intersegment sales	Profit (loss)
Segment:			
Injection molded plastic parts	\$ 54,745	\$ 1,699	\$11,717
Electronic products	40,083	3	5,378
Metallic parts	6,185	2,116	171
	<u> </u>	<u> </u>	<u> </u>
Segment total	\$101,013	\$ 3,818	\$17,266
Reconciliation to consolidated totals:			
Sales eliminations	(3,818)	(3,818)	
Goodwill amortization not allocated to segment			
	<u> </u>	<u> </u>	<u> </u>
Consolidated totals:			
Net sales	\$ 97,195	\$	
	<u> </u>	<u> </u>	
Income before income taxes and minority interests			\$17,266
			<u> </u>

	Year ended March 31,					
	2002		2003		2004	
	Interest income	Interest expenses	Interest income	Interest expenses	Interest income	Interest expenses
Segment:						
Injection molded plastic parts	\$719	\$	\$396	\$	\$230	\$
Electronic products	70	26	26	6	17	16
Metallic parts	14		4		0	
	<u> </u>	<u> </u>	<u> </u>	<u> </u>	<u> </u>	<u> </u>

Consolidated total	\$803	\$ 26	\$426	\$ 6	\$247	\$ 16
---------------------------	-------	-------	-------	------	-------	-------

Year ended March 31,

	2002			2003		
	Identifiable assets	Capital expenditure	Depreciation and amortization	Identifiable assets	Capital expenditure	Depreciation and amortization
Segment:						
Injection molded plastic parts	\$68,165	\$ 3,916	\$ 2,921	\$ 80,335	\$ 8,868	\$ 3,082
Electronic products	24,508	335	1,444	26,400	532	1,190
Metallic parts	4,477	146	518	4,563	331	420
Segment totals	\$97,150	\$ 4,397	\$ 4,883	\$ 111,298	\$ 9,731	\$ 4,692
Reconciliation to consolidated totals:						
Elimination of receivables from intersegments	(2,884)			(5,604)		
Goodwill not allocated to segments	478		35	478		
Consolidated totals	\$94,744	\$ 4,397	\$ 4,918	\$ 106,172	\$ 9,731	\$ 4,692

[Additional columns below]

[Continued from above table, first column(s) repeated]

Year ended March 31,

	2004		
	Identifiable assets	Capital expenditure	Depreciation and amortization
Segment:			
Injection molded plastic parts	\$ 83,391	\$14,285	\$2,992
Electronic products	29,182	5,162	949

Metallic parts	5,083	414	460
	<u> </u>	<u> </u>	<u> </u>
Segment totals	\$ 117,656	\$ 19,861	\$ 4,401
Reconciliation to consolidated totals:			
Elimination of receivables from intersegments	(4,600)		
Goodwill not allocated to segments	478		
	<u> </u>	<u> </u>	<u> </u>
Consolidated totals	\$ 113,534	\$ 19,861	\$ 4,401
	<u> </u>	<u> </u>	<u> </u>

Table of Contents**16. Segment Information - Continued**

The Company's sales are coordinated through the Hong Kong or Macau subsidiaries and a breakdown of sales by destination is as follows:

	Year ended March 31,		
	2002	2003	2004
Net sales			
China	\$46,876	\$53,503	\$50,095
United States of America	19,375	25,949	37,359
Hong Kong	11,690	2,838	2,186
Europe	4,053	7,435	5,778
Others	1,326	1,180	1,777
	<hr/>	<hr/>	<hr/>
Total net sales	\$83,320	\$90,905	97,195
	<hr/>	<hr/>	<hr/>

The location of the Company's identifiable assets is as follows:

	March 31,		
	2002	2003	2004
Hong Kong and Macau	\$53,156	\$ 58,579	\$ 43,660
China	41,110	47,115	69,396
Goodwill	478	478	478
	<hr/>	<hr/>	<hr/>
Total identifiable assets	\$94,744	\$106,172	\$113,534
	<hr/>	<hr/>	<hr/>

Table of Contents**ITEM 19. EXHIBITS**

The following documents are filed as exhibits herewith:

Exhibit No.	Description
1.1	Memorandum and Articles of Association (as amended through March 7, 1995) (incorporated by reference to Exhibit 3.1 to Deswell's Registration Statement on Form F-1 filed with the SEC on June 19, 1995).
1.2	Amendment to Memorandum and Articles of Association filed with BVI Registry of Companies on July 19, 1995 (incorporated by reference to Exhibit 1.2 to Deswell's Annual Report on Form 20-F for the year ended March 31, 2001 filed with the SEC on July 10, 2001).
1.3	Notice of amendment of Memorandum and Articles of Association, with Certified Extract of a Resolution Adopted by the Directors Pursuant to the Articles of Association of the Company on the 8th day of July 2002 (incorporated by reference to Exhibit 1.3 to Deswell's Form 8A/A (Amendment No. 1) filed with the SEC on August 14, 2002).
1.4	Notice of amendment of Memorandum and Articles of Association (Amendment No. 2), with Notice of Increase in Authorised Capital and Certified Extract of a Resolution Adopted by the Directors Pursuant to the Articles of Association of the Company on the 8th day of July 2002 (incorporated by reference to Exhibit 1.4 to Deswell's Form 8A/A (Amendment No. 2) filed with the SEC on August 14, 2002)
2.1	Form of common share certificate (incorporated by reference to Exhibit 4.1 of Amendment No. 1 to Deswell's Registration Statement on Form F-1 filed with the SEC on July 13, 1995).
4.1	Facility letter dated April 8, 2004 between The Hongkong & Shanghai Banking Corporation Limited, Macao Branch (HSBC) and Jetcrown Industrial (Macao Commercial Offshore Limited (JIMCO).
4.2	Facility letter dated May 2, 2003 between Standard Chartered Bank and Kwanasia Electronics Company Limited (incorporated by reference to Exhibit 4.3 of registrant's Form 20-F for the year ended March 31, 2003, filed with the SEC on September 15, 2003).
4.3	Facility letter dated February 23, 2004 between Fortis Bank Asia HK and Kwanasia Electronics Company Limited
4.4	Revolving Short-term Renminbi Loan Facility letter dated November 28, 2002 between UFJ Bank Shenzhen Branch and Dongguan Kwan Hong Electronics Co., Limited (incorporated by reference to Exhibit 4.6 of registrant's Form 20-F for the year ended March 31, 2003, filed with the SEC on September 15, 2003).
4.5	Revolving Short-term Renminbi Loan Facility letter dated May 6, 2003 between Standard Chartered Bank Shenzhen Branch and Dongguan Kwan Hong Electronics Company Limited (incorporated by reference to Exhibit 4.7 of registrant's Form 20-F for the year ended March 31, 2003, filed with the SEC on September 15, 2003).

- 4.6 Tenancy Agreement dated May 29, 2002 between Shekou Yu Yi Shareholding Co. Ltd. and Jetcrown Industrial (Shenzhen) Limited for the 1st and 2nd Floor, Block A, Wing Village Industrial Estate, Shekou, Shenzhen (incorporated by reference to Exhibit 4.8 of registrant's Form 20-F for the year ended March 31, 2003, filed with the SEC on September 15, 2003).
- 4.7 Tenancy Agreement dated May 30, 2003 between Shekou NanShui Enterprises Shareholding Co. Ltd. and Jetcrown Industrial (Shenzhen) Limited for the 2nd to 5th Floor, Block E, Wing Village Industrial Estate, Shekou, Shenzhen (incorporated by reference to Exhibit 4.9 of registrant's Form 20-F for the year ended March 31, 2003, filed with the SEC on September 15, 2003).
- 4.8 Extension from May 1, 2003 to April 30, 2004 of and including Tenancy Agreement dated April 9 and 11, 2001 between Shekou East Empire Industrial Company Limited and Jetcrown Industrial (Shenzhen) Limited for the 2nd Floor to 5th Floor, Block H, Wing Village Industrial Estate, Shekou, Shenzhen (incorporated by reference to Exhibit 4.10 of registrant's Form 20-F for the year ended March 31, 2003, filed with the SEC on September 15, 2003).

Table of Contents

Exhibit No.	Description
4.9	Tenancy Agreement dated December 31, 2002 between Shekou Tai Shen Enterprises Shareholding Co. Ltd. and Jetcrown Industrial (Shenzhen) Limited for Block D (five floors total) Wing Village Industrial Estate, Shekou, Shenzhen (incorporated by reference to Exhibit 4.11 of registrant's Form 20-F for the year ended March 31, 2003, filed with the SEC on September 15, 2003).
4.10	Tenancy Agreement dated January 2, 2003 between Shekou District Yu Yee Shareholding Co. Ltd. and Jetcrown Industrial (Shenzhen) Limited for the 1st to 5th Floor, Block F, Wing Village Industrial Estate, Shekou, Shenzhen (incorporated by reference to Exhibit 4.12 of registrant's Form 20-F for the year ended March 31, 2003, filed with the SEC on September 15, 2003).
4.11	Tenancy Agreement dated December 31, 2003 between Shenzhen Shekou Real Property Company (Lessor) and Jetcrown Industrial (Shenzhen) Limited (Lessee) for Room 201-203, 205-208, 210-214, 305, 307-310, 402-405, 407, 409, 413-414, 416, 502-504, 506-507, 510, 513-516, 601, 603-607, 609-616, 701-716, Block C1, New Wing Village, Shekou.
4.12	Tenancy Agreement dated January 7, 2004 between Shenzhen Shekou Real Property Company (Lessor) and Jetcrown Industrial (Shenzhen) Limited (Lessee) for 1/F-7/F, Block 13, Nanshui Siu Village, Room 201-204, 206, 409 of Block 9, NanShui Siu Village and Room 201 and 311 of Block C3 of New Wing Village, Shekou
4.13	Tenancy Agreement dated January 1, 2004 between Dongguan Houjie Town Chong Hing Trading Company (Lessor) and Jetcrown Industrial (Dongguan) Limited (Lessee) for Lease of a block of industrial building, a block of dormitory, and electricity room at Huangguan Industrial Estate, Ma Tsui, Dongguan.
4.14	Contract on Land and Factory dated February 28, 2003 between Dongguan City Cheung On Town Siu Bin Estate Member Committee and Dongguan Kwan Hong Electronics Co. Ltd. for the land and factory and dormitory buildings on the area between Siu Bin Reservoir and Sai Cheong Road, the second Industrial Zone, Siu Bin Estate, Cheung On Town, Dongguan City and the Attestation Deed dated May 14, 2003 (incorporated by reference to Exhibit 4.14 of registrant's Form 20-F for the year ended March 31, 2003, filed with the SEC on September 15, 2003).
4.15	2001 Stock Option Plan (incorporated by reference to Exhibit A to the Company's Proxy Statement for its 2001 Annual Meeting of Stockholders filed with the SEC under cover of Form 6-K on December 12, 2001.)
4.16	2003 Stock Option Plan (incorporated by reference to Exhibit A to the Company's Proxy Statement for its 2003 Annual Meeting of Stockholders submitted to the SEC under cover of Form 6-K on September 15, 2003.)
8.1	Diagram of the Company's operating subsidiaries and affiliates (see page 20 of this report)
11.1	Code of Ethics
12.1	Certification of Chief Executive Officer required by Rule 13a-14(a) or Rule 15d-14(a) under the Securities Exchange Act of 1934

- 12.2 Certification of Chief Financial Officer required by Rule 13a-14(a) or Rule 15d-14(a) under the Securities Exchange Act of 1934
- 13.1 Certification Pursuant To 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act Of 2002
- 14.1 Consent of BDO International to incorporation of its report on the Company s consolidated financial statements into Registrant s Registration Statements on Form S-8.
- 14.2 Consent of Deloitte Touche Tohmatsu to incorporation of its report on the Company s consolidated financial statements into Registrant s Registration Statements on Form S-8.

Table of Contents

SIGNATURES

Pursuant to the requirements of Section 12 of the Securities Exchange Act of 1934, the registrant certifies that it meets all of the requirements for filing on Form 20-F and has duly caused this annual report to be signed on its behalf by the undersigned thereunto duly authorized.

DESWELL INDUSTRIES, INC.

Date: July 16, 2004

By: /s/ Richard Lau

Richard Lau
Chairman of the Board and
Chief Executive Office