SIMPLETECH INC
Form 10-Q
August 11, 2006
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended June 30, 2006

or

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

Commission File Number 000-31623

SIMPLETECH, INC.

(Exact name of Registrant as specified in its charter)

CALIFORNIA	**33-0399154**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**

3001 Daimler Street

Santa Ana, CA | **92705-5812**
(Address of principal executive offices) | **(Zip Code)**

(949) 476-1180

(Registrant s telephone number, including area code)

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

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

Large Accelerated Filer ¨ Accelerated Filer ¨ Non-Accelerated Filer x

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

The number of shares outstanding of the registrant s common stock, par value $0.001, as of July 31, 2006 was 45,887,417.

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QUARTERLY PERIOD ENDED JUNE 30, 2006

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

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PART I FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

SIMPLETECH, INC.

CONSOLIDATED BALANCE SHEETS

(in thousands, except share and per share amounts)

(unaudited)

	June 30, 2006	December 31, 2005
ASSETS:		
Current Assets:		
Cash and cash equivalents	$ 55,213	$ 60,006
Accounts receivable, net of allowances of $2,375 at June 30, 2006 and $878 at December 31, 2005	50,796	38,630
Inventory, net	44,695	37,108
Deferred income taxes	2,127	1,410
Other current assets	1,841	3,825
Total current assets	154,672	140,979
Furniture, fixtures and equipment, net	10,201	8,231
Intangible assets	914	1,036
Goodwill	1,682	733
Other long-term assets	1,887	1,647
Deferred income taxes	2,299	2,515
Total assets	$ 171,655	$ 155,141
LIABILITIES AND SHAREHOLDERS EQUITY:		
Current Liabilities:		
Accounts payable	$ 28,202	$ 20,564
Accrued and other liabilities (Note 5)	8,939	7,195
Total liabilities	37,141	27,759
Commitments and contingencies (Note 6)		
Shareholders Equity:		
Preferred stock, $0.001 par value, 20,000,000 shares authorized, no shares outstanding		
Common stock, $0.001 par value, 100,000,000 shares authorized, 45,864,917 shares issued and outstanding as of June 30, 2006 and 45,043,568 shares issued and outstanding as of December 31, 2005	46	45
Additional paid-in capital	113,147	111,576
Retained earnings	21,321	15,761
Total shareholders equity	134,514	127,382
Total liabilities and shareholders equity	$ 171,655	$ 155,141

See accompanying notes to unaudited consolidated financial statements.

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SIMPLETECH, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share amounts)

(unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Net revenues	$ 79,519	$ 70,268	$ 145,010	$ 131,516
Cost of revenues	59,815	57,477	112,634	107,741
Gross profit	19,704	12,791	32,376	23,775
Sales and marketing	7,159	6,018	13,045	11,398
General and administrative	3,590	3,102	7,233	6,181
Research and development	2,217	1,616	4,265	2,903
Total operating expenses	12,966	10,736	24,543	20,482
Operating income	6,738	2,055	7,833	3,293
Interest income and other	506	417	981	852
Income before provision for income taxes	7,244	2,472	8,814	4,145
Provision for income taxes	2,725	537	3,254	1,175
Net income	$ 4,519	$ 1,935	$ 5,560	$ 2,970
Net income per share:				
Basic	$ 0.10	$ 0.04	$ 0.12	$ 0.07
Diluted	$ 0.10	$ 0.04	$ 0.12	$ 0.06
Shares used in net income per share computation:				
Basic	45,699	44,638	45,426	45,613
Diluted	46,379	45,772	46,291	46,897

See accompanying notes to unaudited consolidated financial statements.

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SIMPLETECH, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(unaudited)

	Six Months Ended June 30,	
	2006	**2005**
Cash flow from operating activities:		
Net income	$ 5,560	$ 2,970
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	2,014	1,391
Loss (gain) on sale of furniture, fixtures and equipment	1	61
Accounts receivable provisions	2,255	418
Inventory excess and obsolescence expense	1,151	499
Deferred income taxes	(502)	903
Compensation related to stock options vesting	(36)	
Change in operating assets and liabilities:		
Accounts receivable	(15,421)	(3,116)
Inventory	(8,739)	(13,790)
Other assets	1,072	(1,172)
Accounts payable	7,638	1,822
Accrued and other liabilities	1,744	(583)
Net cash (used in) operating activities	(3,263)	(10,597)
Cash flows from investing activities:		
Sales of marketable securities, net		9,972
Acquisition of business	(500)	
Purchase of furniture, fixtures and equipment	(2,639)	(834)
Proceeds from sale of furniture, fixtures and equipment		37
Net cash (used in) provided by investing activities	(3,139)	9,175
Cash flows from financing activities:		
Proceeds from exercise of stock options	1,367	
Tax benefit of employee stock option exercise	242	92
Stock buyback		(11,828)
Proceeds from issuance of common stock		349
Net cash provided by (used in) financing activities	1,609	(11,387)
Net (decrease) increase in cash	(4,793)	(12,809)
Cash and cash equivalents at beginning of period	60,006	73,346
Cash and cash equivalents at end of period	$ 55,213	$ 60,537
Supplemental schedule of noncash investing activities:		
Receivable from Integrated Circuit Solution Incorporation used to fund acquisition	$ 1,000	

See accompanying notes to unaudited consolidated financial statements.

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SIMPLETECH, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 1 Basis of Presentation

The accompanying interim consolidated financial statements of SimpleTech, Inc., a California corporation (the Company), are unaudited and have been prepared in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X. In the opinion of management, all normal and recurring adjustments considered necessary for a fair statement of the consolidated financial position of the Company at June 30, 2006, the consolidated results of operations for each of the three and six months ended June 30, 2006 and 2005, and the consolidated results of cash flows for each of the six months ended June 30, 2006 and 2005, have been included. These interim consolidated financial statements should be read in conjunction with the consolidated financial statements and related notes contained in the most recent Annual Report on Form 10-K filed with the SEC. The December 31, 2005 balances reported herein are derived from the audited consolidated financial statements included in the Annual Report on Form 10-K for the year ended December 31, 2005. The results for the interim periods are not necessarily indicative of results to be expected for the full year.

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

Note 2 Summary of Significant Accounting Policies

Reclassifications:

Certain reclassifications have been made to the prior period consolidated financial statements to conform to the current quarter presentation.

Use of Estimates:

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

Concentrations:

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

	For the Three Months Ended June 30,				For the Six Months Ended June 30,			
	2006		2005		2006		2005	
	Accounts Receivable	Revenues	Accounts Receivable	Revenues	Accounts Receivable	Revenues	Accounts Receivable	Revenues
Customer A	20%	23%	27%	24%	20%	23%	27%	22%
Customer B	*	13%	*	15%	*	14%	*	10%
Customer C	*	12%	*	15%	*	12%	*	16%
Total	20%	48%	27%	54%	20%	49%	27%	48%

* Less than 10%

For each of the three-month periods ended June 30, 2006 and 2005, international sales comprised 14% and 13%, respectively, of the Company s revenues. For each of the six-month periods ended June 30, 2006 and 2005, international sales comprised 13% of the Company s revenues.

During these periods, no single foreign country accounted for more than 10% of revenues. Substantially all of the Company s international sales are export sales, which are shipped from the Company s domestic facility to foreign customers.

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Warranties:

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

Sales and marketing incentives:

Sales and marketing incentives were offset against revenues or charged to operations in accordance with Emerging Issues Task Force (EITF) Issue No. 01-09, Accounting for Consideration Given by a Vendor to a Customer or a Reseller of the Vendor Products. Sales and marketing incentives amounted to $3.3 million and $2.3 million for each of the three months ended June 30, 2006 and 2005, respectively, of which $3.2 million and $2.1 million, respectively, were offset against revenues, and $121,000 and $184,000, respectively, were charged as an operating expense. Sales and marketing incentives amounted to $6.1 million and $4.5 million for each of the six months ended June 30, 2006 and 2005, respectively, of which $6.0 million and $4.2 million, respectively, were offset against revenues, and $131,000 and $340,000, respectively were charged as an operating expense.

Consideration generally given by the Company to a customer is presumed to be a reduction of selling price, and therefore, a reduction of revenue. However, if the Company receives an identifiable benefit in return for the consideration given to its customer that is sufficiently separable from the Company s sales to that customer, such that the Company could have paid an independent company to receive that benefit; and the Company can reasonably estimate the fair value of that benefit, then the consideration is characterized as an expense. The Company estimates the fair value of the benefits it receives by tracking the advertising done by its customers on the Company s behalf and calculating the value of that advertising using a comparable rate for similar publications.

Shipping and handling costs:

Shipping and handling costs incurred in a sales transaction to ship products to a customer are included in sales and marketing expenses. For each of the three and six months ended June 30, 2006 shipping and handling costs were $988,000 and $1.7 million, respectively compared to $568,000 and $1.0 million for each of the three and six months ended June 30, 2005, respectively. Amounts billed to customers for shipping and handling are included in revenues. For each of the three and six months ended June 30, 2006 shipping and handling costs billed to customers were $65,000 and $158,000, respectively compared to $102,000 and $174,000 for each of the three and six months ended June 30, 2005, respectively.

Income taxes:

Deferred income taxes are recognized for the tax consequences in future years of differences between the tax bases of assets and liabilities and their financial reporting amounts at each year-end based on enacted tax laws and statutory rates applicable to the periods in which the differences are expected to affect taxable income. Valuation allowances are established, when necessary, to reduce deferred income tax assets to the amount expected to be realized. The provision for income taxes represents the tax payable for the year and the change during the year in deferred income tax assets and liabilities. The difference between the effective tax rate and the U.S. statutory tax rate for each of the three months ended June 30, 2006 and 2005 reflects the benefit of tax exempt interest income, the recognition of federal tax credits related to research and development in 2005 increased by the net impact of state taxes in 2006 and decreased by the state benefit related to research and development credits and enterprise zone hiring credits in 2005 and 2006.

New accounting pronouncements:

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

In March 2006, the FASB issued Statement of Financial Accounting Standards No. 156, Accounting for Servicing of Financial Assets an amendment of FASB Statement No. 140 which is effective for fiscal years beginning after September 15, 2006. This statement was issued to simplify the accounting for servicing rights and to reduce the volatility that results

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from using different measurement attributes. The Company has evaluated the new statement and has determined that it will not have a significant impact on the determination or reporting of the Company s financial results.

In July 2006, the FASB issued FIN 48, which clarifies the accounting for uncertainty in tax positions. This Interpretation requires that the Company recognize in its financial statements, the impact of a tax position, if that position is more likely than not of being sustained on audit, based on the technical merits of the position. The provisions of FIN 48 are effective as of the beginning of the Company s 2007 fiscal year, with the cumulative effect of the change in accounting principle recorded as an adjustment to opening retained earnings. The Company is currently evaluating the impact of adopting FIN 48 on its financial statements.

Note 3 Acquisition

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

The acquisition was accounted for as a purchase under SFAS No. 141, Business Combinations. The valuation is not finalized and the preliminary allocation of the excess of the purchase price over the estimated fair value of the net tangible assets acquired is included in goodwill as follows:

(In thousands)	
Current assets	$ 0
Fixed assets	1,050
Fair value of tangible assets acquired	1,050
Goodwill	450
Consideration	$ 1,500

Note 4 Net Income (Loss) Per Share

Basic earnings per share is computed by dividing net income (loss) by the weighted average number of shares outstanding. In computing diluted earnings per share, the weighted average number of shares outstanding is adjusted to reflect the potentially dilutive securities. Options to purchase 9,412,755 and 10,281,857 shares of common stock were outstanding at June 30, 2006 and 2005, respectively. In addition, 50,000 restricted stock units payable in shares of common stock were outstanding at June 30, 2006. There were no outstanding restricted stock units at June 30, 2005. For the three months ended June 30, 2006 and 2005, potentially dilutive securities consisted solely of options and restricted stock units and resulted in potential common shares of 679,912 and 1,134,516, respectively. For the six months ended June 30, 2006 and 2005, potentially dilutive securities consisted solely of options and restricted stock units and resulted in potential common shares of 865,378 and 1,283,755, respectively.

Share-Based Compensation

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

On December 19, 2005, the Company s board of directors approved the termination of its Employee Stock Purchase Plan (ESPP) and the acceleration of the vesting of all then current unvested stock options awarded under its 2000 Stock Incentive Plan, including stock options held by its employees, officers, directors and consultants. These unvested stock options consisted of both in-the-money as well as out-of-the-money options. Based upon the closing price of SimpleTech common stock of $3.79 per share on December 19, 2005, approximately 47% of the total accelerated stock options were in-the-money with a weighted average exercise price of $3.20 per share. In accordance with SFAS 123, the Company expensed

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the remaining unrecognized compensation expense associated with the options with accelerated vesting in the pro forma disclosure. The decision to terminate the ESPP and accelerate vesting of the stock options was made primarily to avoid recognizing the related compensation expense in the Company s future consolidated financial statements with respect to the shares issued under the ESPP and the unvested stock options upon the Company s adoption of Statement SFAS 123(R) on January 1, 2006. As a result of adopting FAS 123(R) on January 1, 2006, the Company s share based compensation expense related to stock options was $4,000 and $6,000 for the three and six months ended June 30, 2006, respectively. In addition, the Company s share based compensation expense related to restricted stock was $5,000 for the three and six months ended June 30, 2006.

Prior to the adoption of SFAS 123(R), the Company accounted for stock-based awards to employees and directors using the intrinsic value method in accordance with Accounting Principles Board (APB) Opinion No. 25 as allowed under Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation (SFAS 123). Under the intrinsic value method, no stock-based compensation expense had been recognized in the Company s consolidated statement of operations because the exercise price of the Company s stock options granted to employees and directors equaled the fair market value of the underlying stock at the date of grant.

For purposes of pro forma disclosures, the estimated fair value of the options is amortized to expense over the options vesting period. The table below sets forth the Company s pro forma information for the three and six months ended June 30, 2005, assuming the Company had determined compensation expense for awards under stock option plans based on the fair value at the grant date.

	Three Months Ended June 30, 2005	Six Months Ended June 30, 2005
Net income, as reported	$ 1,935	$ 2,970
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(1,021)	(1,950)
Pro forma net income	$ 914	$ 1,020
Income per share:		
Basic as reported	$ 0.04	$ 0.07
Basic pro forma	$ 0.02	$ 0.02
Diluted as reported	$ 0.04	$ 0.06
Diluted pro forma	$ 0.02	$ 0.02

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

Note 5 Supplemental Balance Sheet Information

Inventory consists of the following:

(in thousands)	June 30, 2006	December 31, 2005
Raw materials	$ 19,639	$ 22,994
Work-in-progress	6,258	1,132
Finished goods	21,815	14,938
	47,712	39,064
Valuation allowances	(3,017)	(1,956)

Inventory, net	$ 44,695	$ 37,108

We have had to write-down inventory in the past for reasons such as obsolescence, excess quantities and declines in market value below our costs. These inventory write-downs were $989,000 and $1,151,000 in the three and six months ended June 30, 2006, compared to $456,000 and $499,000 in the three and six months ended June 30, 2005. In addition, we offer some of our Consumer Division customers limited price protection rights for inventories of our products held by them. If we reduce the list price of our products, these customers may receive credits from us. We incurred price protection charges of $595,000 and $1,333,000 in the three and six months ended June 30, 2006, compared to $0 and $551,000 in the three and six months ended June 30, 2005. We also offer rebate programs through some of our Consumer Division customers to end-users. We incurred rebate charges of $562,000 and $1,279,000 in the three and six months ended June 30, 2006, compared to $205,000 and $330,000 in the three and six months ended June 30, 2005. Rebate charges increased significantly in the three and six months ended June 30, 2006 compared to the three and six months ended June 30, 2005 due primarily to the expansion of our revenues from the retail channel, which typically involves the frequent use of rebate programs.

Accrued and other liabilities consisted of the following as of:

(in thousands)	**June 30, 2006**	**December 31, 2005**
Payroll costs	$ 3,888	$ 3,423
Marketing	1,799	2,148

(in thousands)	June 30, 2006	December 31, 2005
Other	3,252	1,624
Total	$ 8,939	$ 7,195

Note 6 Commitments and Contingencies

Lemelson Medical, Education & Research Foundation, LLP Patent Infringement

The Company received notice on November 26, 2001 that the Lemelson Medical, Education & Research Foundation, LLP (Lemelson Foundation) filed a complaint on November 13, 2001 against the Company and other defendants. The complaint was filed in the District Court of Arizona and alleges that the Company s manufacturing processes infringe several patents that the Lemelson Foundation allegedly owns. The complaint also states that these allegedly infringed patents relate to machine vision technology and bar coding technology. On March 7, 2002, the Company was served with the Lemelson Foundation complaint. Thereafter, the case was stayed pending the outcome of related cases against other parties involving the same patents. On September 9, 2005, in one of these related cases, the U.S. Court of Appeals for the Federal Circuit affirmed a decision by the U.S. District Court for the District of Nevada that found several Lemelson Foundation patents to be unenforceable. Because the final outcome of the related cases are expected to affect the Lemelson Foundation s lawsuit against the Company, an estimate of potential damages, if any, would be premature and speculative. The Company believes this lawsuit is without merit and it intends to vigorously defend itself against it.

Other Legal Proceedings

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

Indemnification

The Company has agreements whereby the Company indemnifies its officers and directors over his or her lifetime for certain events or occurrences while the officer or director is, or was serving, at the Company s request in such capacity. The maximum potential amount of future payments the Company could be required to make under these indemnification agreements is unlimited; however, the Company has a director and officer insurance policy that limits the Company s exposure and should enable the Company to recover a portion of any future amounts paid. As a result of the Company s insurance policy coverage, the Company believes the estimated potential liability related to these indemnification agreements is minimal. All of these indemnification agreements, except for the agreement for James Peterson and Rajat Bahri who joined the Board of Directors in January 2003 and November 2005, respectively, were grandfathered under the provisions of Financial Accounting Standards Board interpretation (FIN) No. 45, Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others an Interpretation of FASB Statements No. 5, 57 and 107 and Rescission of FASB Interpretation No. 34, as they were in effect prior to December 31, 2002. Accordingly, the Company has no liabilities recorded for these agreements as of June 30, 2006.

As is common in the industry, the Company currently has in effect a number of agreements in which the Company has agreed to defend, indemnify and hold harmless certain of its suppliers and customers from damages and costs which may arise from the infringement by the Company s products of third-party patents, trademarks or other proprietary rights. The scope of such indemnity varies, but may, in some instances, include indemnification for damages and expenses, including attorneys fees. The Company s insurance does not cover intellectual property infringement. The term of these indemnification agreements is generally perpetual any time after execution of the agreement. The maximum potential amount of future payments the Company could be required to make under these indemnification agreements is unlimited. The Company has never incurred significant costs to defend lawsuits or settle claims related to these indemnification agreements. As a result, the Company believes the estimated fair value of these agreements is minimal. Accordingly, the Company has no liabilities recorded for these agreements as of June 30, 2006.

Other Commitments

The Company is subject to repurchase agreements with various financial institutions in connection with wholesale inventory financing. Under these agreements, the Company may be required to repurchase inventory upon customer default with a financing institution and then resell the inventory through normal distribution channels. As of June 30, 2006, the Company has not been required to repurchase inventory in connection with the customer default agreements noted above. However, it may be possible that the Company will be required to repurchase inventory,

upon customer default, in the future. Sales under

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such agreements were approximately $190,000 and $176,000 in each of the three months ended June 30, 2006 and 2005, respectively, and $374,000 and $701,000 in the six months ended June 30, 2006 and 2005, respectively.

Note 7 Segment Information

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

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

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

(In thousands)

	Three Months Ended June 30, 2006		
	Net Revenues	Cost of Revenues	Gross Profit
Consumer:			
Standard Memory	$ 11,824	$ 9,860	$ 1,964
Flash Memory	7,052	6,099	953
Stacked Memory	704	594	110
Hard Drive	12,658	11,524	1,134
	$ 32,238	$ 28,077	$ 4,161
OEM:			
Standard Memory	$ 6,024	$ 5,013	$ 1,011
Flash Memory	20,418	9,892	10,526
Stacked Memory	20,786	16,807	3,979
Other	53	26	27
	$ 47,281	$ 31,738	$ 15,543
Total:			
Standard Memory	$ 17,848	$ 14,873	$ 2,975
Flash Memory	27,470	15,991	11,479
Stacked Memory	21,490	17,401	4,089
Hard Drive/other	12,711	11,550	1,161
	$ 79,519	$ 59,815	$ 19,704

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	Three Months Ended June 30, 2005		
	Net Revenues	Cost of Revenues	Gross Profit
Consumer:			
Standard Memory	$ 14,908	$ 12,895	$ 2,013
Flash Memory	7,802	7,057	745
Stacked Memory	1,186	952	234
Hard Drive	8,314	6,980	1,334
	$ 32,210	$ 27,884	$ 4,326
OEM:			
Standard Memory	$ 7,817	$ 6,220	$ 1,597
Flash Memory	7,214	4,225	2,989
Stacked Memory	22,927	19,102	3,825
Other	100	46	54
	$ 38,058	$ 29,593	$ 8,465
Total:			
Standard Memory	$ 22,725	$ 19,115	$ 3,610
Flash Memory	15,016	11,282	3,734
Stacked Memory	24,113	20,054	4,059
Hard Drive/other	8,414	7,026	1,388
	$ 70,268	$ 57,477	$ 12,791

	Six Months Ended June 30, 2006		
	Net Revenues	Cost of Revenues	Gross Profit
Consumer:			
Standard Memory	$ 21,842	$ 18,320	$ 3,522
Flash Memory	11,317	9,968	1,349
Stacked Memory	1,614	1,376	238
Hard Drive	22,524	19,968	2,556
	$ 57,297	$ 49,632	$ 7,665
OEM:			
Standard Memory	$ 11,456	$ 9,603	$ 1,853
Flash Memory	37,218	20,799	16,419
Stacked Memory	38,901	32,533	6,368
Other	138	67	71
	$ 87,713	$ 63,002	$ 24,711
Total:			
Standard Memory	$ 33,298	$ 27,923	$ 5,375
Flash Memory	48,535	30,767	17,768
Stacked Memory	40,515	33,909	6,606

Hard Drive/other	22,662	20,035	2,627
	$ 145,010	$ 112,634	$ 32,376

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	Six Months Ended June 30, 2005		
	Net Revenues	Cost of Revenues	Gross Profit
Consumer:			
Standard Memory	$ 33,452	$ 29,412	$ 4,040
Flash Memory	16,396	14,779	1,617
Stacked Memory	3,160	2,450	710
Hard Drive	13,533	11,137	2,396
	$ 66,541	$ 57,778	$ 8,763
OEM:			
Standard Memory	$ 13,538	$ 10,845	$ 2,693
Flash Memory	12,120	6,911	5,209
Stacked Memory	38,958	32,043	6,915
Other	359	164	195
	$ 64,975	$ 49,963	$ 15,012
Total:			
Standard Memory	$ 46,990	$ 40,257	$ 6,733
Flash Memory	28,516	21,690	6,826
Stacked Memory	42,118	34,493	7,625
Hard Drive/other	13,892	11,301	2,591
	$ 131,516	$ 107,741	$ 23,775

Note 8 Intangible Assets and Goodwill

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

	As of June 30, 2006			As of December 31, 2005		
	Gross	Accumulated Amortization	Net	Gross	Accumulated Amortization	Net
Developed technology (five years)	$ 400,000	$ 146,000	$ 254,000	$ 400,000	$ 107,000	$ 293,000
Customer relationships (five years)	900,000	240,000	660,000	900,000	157,000	743,000
Total intangible assets	$ 1,300,000	386,000	$ 914,000	$ 1,300,000	$ 264,000	$ 1,036,000
Goodwill	$ 1,682,000	$ 0	$ 1,682,000	$ 733,000	$ 0	$ 733,000

In accordance with SFAS 142, Goodwill and Other Intangible Assets, goodwill and other intangible assets with indeterminate lives are not subject to amortization but are tested for impairment annually or whenever events or changes in circumstances indicate that the asset might be impaired. The increase of $949,000 in goodwill is the result of $450,000 related to the acquisition of the flash controller group of the logic division of Integrated Circuit Solution Incorporation on January 15, 2006 and due to the Company determining the final tax liability of $499,000 related to the acquisition of Memtech SSD, Corporation. This tax liability related to Memtech s fiscal year ended June 30, 2005 and was recorded to goodwill in the first quarter of 2006. Intangible assets with finite lives continue to be subject to amortization, and any impairment is determined in accordance with SFAS 144, Accounting for the Impairment or Disposal of Long-Lived Assets. The Company recorded amortization expense for the three months ended June 30, 2006 of $61,000 and for the three months ended June 30, 2005 of $20,000. Estimated intangible asset amortization expense (based on existing intangible assets) for the years ending December 31, 2006, 2007, 2008, 2009 and 2010 is $245,000, $245,000, $245,000, $218,000, and $83,000, respectively. Amortization is complete as of the end of 2010.

Note 9 Shareholders Equity

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

and consultants. Restricted stock units are share awards that entitle the holder to receive shares of the Company s common stock upon vesting. The Company s board of directors or its compensation committee determines eligibility and vesting schedules for options and restricted stock units granted under the Plan. Options expire within a period of not more than ten years from the date of grant.

At June 30, 2006, the Plan provided for the issuance of up to 17,226,645 shares of common stock. The number of shares of common stock reserved for issuance under the Plan will automatically increase on the first trading day in January in each calendar year by an amount equal to 4% of the total number of shares of common stock outstanding on the last trading day in December of the prior calendar year, but in no event will exceed 2,500,000 shares.

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

	Shares	Weighted-Avg Option Price	Weighted-Avg Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding, December 31, 2005	10,452,888	$ 4.25		
Granted	25,000	4.16		
Exercised	(821,349)	1.66		
Forfeited/Expired	(243,784)	5.45		
Outstanding, June 30, 2006	9,412,755	4.44	7.44	$ 2,083,000
Exercisable, June 30, 2006	9,387,755	4.44	7.44	2,083,000

The Company received $1,367,000 in cash proceeds for the exercise of 821,349 options with a $242,000 tax benefit for disqualifying dispositions of incentive stock options. The intrinsic value for options exercised for the three and six months ended June 30, 2006 was $1,267,000 and $1,779,000, respectively.

As of June 30, 2006, total unrecognized compensation expense related to unvested share-based compensation arrangements already granted under the Plan was $61,000, which the Company expects to recognize over a weighted-average period of 3.7 years.

At June 30, 2006, 3,477,218 shares of common stock were available for grant under the Plan.

	Options Outstanding			Exercisable	
Range of Exercise Prices	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Life (Years)	Number of Shares	Weighted Average Exercise Price
$1.50 to $2.20	56,195	$ 1.94	5.61	56,195	$ 1.94
$2.20 to $3.30	2,396,513	3.00	6.63	2,396,513	3.00
$3.30 to $5.50	4,216,852	3.97	8.46	4,191,852	3.97
$5.50 to $6.60	1,944,495	5.77	6.11	1,944,495	5.77
$6.60 to $11.00	798,700	8.14	7.98	798,700	8.14
	9,412,755			9,387,755	

There were no stock options granted during the three months ended June 30, 2006.

The Company has not and does not expect to pay dividends, therefore, no specific dividend yield is utilized under the Black-Scholes option pricing model. The risk-free interest rate assumption is based upon observed interest rates appropriate for the term of the Company s employees

stock option grants. The volatility assumption used to value option grants is based exclusively on the Company s historical available closing stock price information. The Company can rely exclusively on this historical information if (1) the Company has no reason to believe that its future volatility over the expected or contractual term is likely to differ from the past, (2) the computation of historical volatility uses a simple average calculation method, (3)

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a sequential period of historical data at least equals the expected or contractual term of the share options is used and (4) a reasonably sufficient number of price observations are used. The expected life of employee stock options represents the historical weighted-average period the stock options are expected to remain outstanding. The expected life of employees stock option grants are impacted by all of the underlying assumptions used in the Company s model. The Black-Scholes option pricing model assumes that employees exercise behavior is a function of the options remaining contractual life and the extent to which the option is in-the-money. The Black-Scholes option pricing model estimates the probability of exercise as a function of these two variables based on the history of exercises and cancellations of past option grants made by the Company.

During the three months ended June 30, 2006, the Company issued 50,000 restricted stock units with a grant fair value of $3.89 per share determined by the closing price of the common stock on the issuance date of May 25, 2006. Each unit represents the right to receive one share of the Company s common stock as each restricted stock unit vests. The Company records compensation expense for the amount of the grant date fair value over the period which the restrictions lapse. There were no outstanding restricted stock units as of June 30, 2005.

The following table presents a summary of the status of the Company s restricted stock units as of December 31, 2005, and changes during the six months ended June 30, 2006:

	Restricted Units	Weighted Average Grant Fair Value
Non-vested restricted units at December 31, 2005		
Granted	50,000	$ 3.89
Forfeited		
Non-vested restricted units at June 30, 2006	50,000	$ 3.89

As of June 30, 2006, there was approximately $190,000 of total unrecognized compensation expense related to non-vested restricted stock units granted under the Plan, as amended and restated.

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ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS
Cautionary Statement

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

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

Overview

SimpleTech, Inc. was originally incorporated in California in March 1990 as Simple Technology, Inc. Our name was then changed to SimpleTech, Inc. in May 2001. SimpleTech designs, develops, manufactures and markets custom and open-standard memory solutions based on Flash memory and DRAM technologies and external storage solutions. Headquartered in Santa Ana, California, we specialize in developing high-density DRAM memory modules and high-speed, high-capacity Flash solutions and memory cards used in sensitive and highly-volatile environments.

We sell our products through our Consumer and OEM Divisions. Our Consumer Division sells our products through a variety of distribution channels, including VARs, mail order, distributors, and mass market retailers. Our OEM Division markets our products to OEMs, leveraging our custom design capabilities to offer custom memory solutions to address their specific needs.

We are focusing on several revenue growth initiatives, including:

- Developing and qualifying customized OEM Flash-based products for industrial applications;
- Targeting new customers for our value-add OEM DRAM memory solutions;
- Increasing retail sales of our storage product line; and
- Expanding our international OEM business in Asia and Europe.

Over the past several years we have expanded our custom design capabilities of Flash products for OEM applications. We have invested significantly in the design and development of customized OEM Flash controllers, firmware and hardware form factors. We expanded our OEM Flash design capabilities and sales and marketing infrastructure through our acquisition in July 2005 of Memtech SSD, Corporation, a provider of ultra-rugged and reliable solid state Flash drives. The acquisition highlighted our continuing commitment to the OEM Flash market and enabled us to create one of the most comprehensive offerings of solid state drives and other Flash-based solutions for industrial and military applications. In January 2006, we acquired substantially all of the assets of a division of Integrated Circuit Solution Incorporation, a Taiwanese company, and added a team of engineers in Taiwan specializing in Flash controller design. We believe that our continued investment in this area will positively impact the future growth of our OEM Flash revenues.

OEM Flash product revenue increased 183.3% from $7.2 million in the second quarter of 2005 to $20.4 million in the second quarter of 2006, and 207.4% from $12.1 million in the first half of 2005 to $37.2 million in the first half of 2006. We expect continued revenue growth from our OEM Flash product line for the remainder of 2006. OEM Flash product gross margins were our highest gross margin product line in each of the second quarters of 2006 and 2005 and the first half of 2006 and 2005.

We offer monolithic DRAM memory modules and DRAM memory modules based on our stacking technology. The majority of our Consumer DRAM business has been comprised of monolithic DRAM memory modules. Prior to 2005, the substantial majority of our OEM DRAM business has been comprised of stacked DRAM memory modules. As a result of the introduction of new DRAM technologies, we expect that a higher percentage of our OEM DRAM business will be derived from monolithic DRAM memory modules. In recent quarters, our OEM stacked DRAM memory module revenues have been

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volatile and difficult to project, and we expect this product line to remain difficult to project for the next several quarters as our customers continue to qualify the latest generation modules.

In the past few years, we have invested in the design, development and launch of our product line of 3.5 , 3.5 NAS, 2.5 and 1 consumer external storage drives. As a result of our penetration into numerous major U.S. retailers in the past year and the introduction of our new form factor designed by the Pininfarina Group in Turin, Italy, we believe this product line is gaining momentum. Our external storage product revenue increased from $8.3 million in the second quarter of 2005 to $12.7 million in the second quarter of 2006.

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

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

Historically, a limited number of customers have accounted for a significant percentage of our revenue. Our ten largest customers accounted for an aggregate of 67.8% of our revenues in the first half of 2006, compared to 69.3% of our total revenues in the first half of 2005, and 68.8% of our revenues in the second quarter of 2006, compared to 70.9% of our revenues in the second quarter of 2005. The following table identifies each of our customers that accounted for more than 10.0% of our revenues in any of the three months and six months ended June 30, 2006 and 2005.

	Percentage of Revenues for the Three Months Ended June 30,		Percentage of Revenues for the Six Months Ended June 30,	
Customer	**2006**	**2005**	**2006**	**2005**
CDW Logistics, Inc. (formerly CDW Computer Centers)	11.8%	14.5%	12.1%	16.1%
Micron Semiconductor	12.7%	14.7%	13.6%	*
Smart Modular	23.4%	23.8%	22.7%	21.6%

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

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

International sales of our products accounted for 13.4% of our revenues in the first half of 2006, compared to 12.5% of our revenues in the first half of 2005, and 13.8% of our revenues in the second quarter 2006, compared to 12.5% of our revenues in the second quarter of 2005. No foreign geographic area or single foreign country accounted for more than 10.0% of our revenues in each of the three and six months ended June 30, 2006 or 2005. For the three and six months ended June 30, 2006 and 2005, more than 95.0% of our international sales were denominated in U.S. dollars. In addition, our purchases of DRAM and Flash components are currently denominated in U.S. dollars. However, we do face risks associated with doing business in foreign countries. See Risk Factors We face risks associated with doing business in foreign countries, including foreign currency fluctuations and trade barriers, that could lead to a decrease in demand for our products or an increase in the cost of the components used in our products.

In the past, we have been, and expect to continue to be, impacted by seasonal purchasing patterns resulting in lower sales in the first and second quarters of each year. Other factors, including component price fluctuations and the launch of sales of products to new customers, may distort the effect of seasonality. Our ability to adjust our short-term operating expenses in response to fluctuations in revenues is limited. As a result, should revenues decrease to a level lower than expected in any given period, our results of operations would be harmed.

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

On December 19, 2005, our board of directors terminated our Employee Stock Purchase Plan, or ESPP, and approved the acceleration of the vesting of all then current unvested stock options awarded under our 2000 Stock Incentive Plan, including options held by our employees, officers, directors and consultants. All other terms and conditions applicable to such stock options, including the exercise prices, remain unchanged. The decision to terminate the ESPP and accelerate vesting of the stock options was made primarily to avoid recognizing the related compensation expense in our future consolidated financial statements with respect to the shares issued under the ESPP and the unvested stock options upon our adoption of SFAS 123(R) on January 1, 2006. As a result of our adoption of SFAS 123(R), we are required to record compensation expense for all awards granted on and after January 1, 2006 and for the unvested portion of previously granted awards that remain outstanding as of December 31, 2005. We had outstanding unvested stock options to purchase an aggregate of 25,000 shares of common stock at June 30, 2006 and no outstanding unvested stock options as of December 31, 2005. In addition, we had 50,000 outstanding unvested restricted stock units at June 30, 2006 and no outstanding unvested restricted stock units as of December 31, 2005. Each restricted stock unit represents the right to receive one share of common stock as each restricted stock unit vests. For the three and six months ended June 30, 2006, we recorded stock-based compensation expense of $9,000 and $11,000, respectively, consisting of expenses related to employee stock options and employee restricted stock units which are included in research and development and general and administrative expenses. As of June 30, 2006, total unrecognized compensation expense related to unvested share-based compensation arrangements already granted under our 2000 Stock Incentive Plan was $250,000, which we expect will be recognized over a weighted-average period of 3.7 years. We believe SFAS 123(R) will increase our compensation expense, could make our operating results less predictable and affect the way we compensate our employees or cause other changes in the way we conduct our business. As a result of our adoption of SFAS 123(R), we have begun to significantly reduce the use and quantity of stock options compared to the quantity of stock options we granted in recent years. See Notes 4 and 9 to our unaudited consolidated financial statements for additional information concerning our adoption of SFAS 123(R) and our 2000 Stock Incentive Plan.

Results of Operations

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

	Three Months Ended June 30,		**Six Months Ended June 30,**	
	2006	**2005**	**2006**	**2005**
Net revenues	100.0%	100.0%	100.0%	100.0%
Cost of revenues	75.2	81.8	77.7	81.9
Gross profit	24.8	18.2	22.3	18.1
Operating expenses:				
Sales and marketing	9.0	8.6	9.0	8.7
General and administrative	4.5	4.4	5.0	4.7
Research and development	2.8	2.3	2.9	2.2
Total operating expenses	16.3	15.3	16.9	15.6
Operating income	8.5	2.9	5.4	2.5
Interest income	0.6	0.6	0.7	0.7
Income before provision for income taxes	9.1	3.5	6.1	3.2
Provision for income tax	3.4	0.7	2.3	0.9
Net income	5.7	2.8	3.8	2.3

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Comparison of Three Months Ended June 30, 2006 to Three Months Ended June 30, 2005

Net Revenues. Our revenues were $79.5 million in the second quarter of 2006, compared to $70.3 million in the same period in 2005. Revenues increased 13.1% in the second quarter of 2006 due primarily to a 70.3% increase in unit shipments, partially offset by a 33.3% decrease in average sales price, or ASP, from $66 in the second quarter of 2005 to $44 in the second quarter of 2006. The decrease in our ASP resulted primarily from a shift in product mix and declining DRAM and Flash component prices. The increase in unit shipments resulted primarily from a 277.8% increase in OEM Flash memory units shipped and a 61.1% increase in Consumer external storage units shipped, partially offset by a 29.6% decrease in Consumer standard DRAM units shipped. OEM Flash product shipments increased from 153,000 units in the second quarter of 2005 to 578,000 units in the second quarter of 2006. Consumer external storage product shipments increased from 90,000 units in the second quarter of 2005 to 145,000 units in the second quarter of 2006.

Our Consumer Division revenues remained flat at $32.2 million in each of the second quarters of 2005 and 2006. Consumer Division standard memory revenues decreased by 20.7%, Flash memory revenues decreased by 9.6% and stacked memory revenues decreased by 40.6% in the second quarter of 2006. In addition, the ASP for Consumer Division products decreased by 30.0%. These decreases were offset by an increase of 52.2% in revenues from Consumer Division external storage sales and a 43.0% increase in units shipped.

Our OEM Division revenues increased 24.1% from $38.1 million in the second quarter of 2005 to $47.3 million in the second quarter of 2006. The increase in OEM Division revenues was due primarily to a 127.9% increase in OEM Division units shipped, partially offset by a 45.5% decrease in ASP from $112 in the second quarter of 2005 to $61 in the second quarter of 2006. The increase in OEM Division unit volume resulted primarily from an increase in Flash memory units shipped from 153,000 units in the second quarter of 2005 to 578,000 units in the second quarter of 2006. The decrease in our OEM Division ASP resulted primarily from a significant shift in product mix toward lower-ASP, lower-capacity (but higher gross margin), Flash memory products.

Sales of our products are made under short-term cancelable purchase orders. We include in our backlog only those customer orders for which we have accepted purchase orders and to which we have assigned shipment dates within the upcoming six months. Since orders constituting our backlog are subject to change due to, among other things, customer cancellations and reschedulings, and our ability to procure necessary components, backlog is not necessarily an indication of future revenues. In addition, there can be no assurance that current backlog will necessarily lead to revenues in any future period. Our combined backlog was $28.0 million as of June 30, 2006, compared to $17.9 million as of June 30, 2005. Our Consumer Division backlog was $6.6 million as of June 30, 2006, compared to $2.6 million as of June 30, 2005. Our OEM Division backlog was $21.4 million as of June 30, 2006, compared to $15.3 million as of June 30, 2005. The increase in backlog at June 30, 2006 compared to June 30, 2005 was primarily due to increased orders primarily for our OEM Flash and Consumer external storage product lines in the second quarter of 2006. Our ability to predict future sales is limited because a majority of our quarterly product revenues come from orders that are received and fulfilled in the same quarter.

Gross Profit. Our gross profit was $19.7 million in the second quarter of 2006, compared to $12.8 million in the same period in 2005. Gross profit as a percentage of revenues was 24.8% in the second quarter of 2006, compared to 18.2% in the second quarter of 2005. Gross profit as a percentage of revenue in the second quarter of 2006 increased due primarily to a shift in product mix toward higher gross profit margin OEM products. Gross profit for our Consumer Division as a percentage of Consumer Division revenues decreased from 13.4% in the second quarter of 2005 to 12.9% in the second quarter of 2006. Gross profit for our OEM Division as a percentage of OEM Division revenues increased from 22.2% in the second quarter of 2005 to 32.9% in the second quarter of 2006. This increase in gross profit as a percentage of revenues for our OEM Division resulted primarily from an increase in OEM Flash product gross profit margin from 41.4% in the second quarter of 2005 to 51.6% in the second quarter of 2006 and an increase in overall revenues from OEM Flash products from $7.2 million in the second quarter of 2005 to $20.4 million in the second quarter of 2006.

Sales and Marketing. Sales and marketing expenses are primarily comprised of personnel costs and travel expenses for our domestic and international sales and marketing employees, commissions paid to internal salespersons and independent manufacturers representatives, shipping costs and marketing programs. Sales and marketing expenses were $7.2 million in the second quarter of 2006, compared to $6.0 million in the second quarter of 2005. Sales and marketing expenses as a percentage of revenue were 9.0% in the second quarter of 2006, compared to 8.6% in the second quarter of 2005. The increase in sales and marketing expenses in absolute dollars and as a percentage of revenue was due primarily to an increase in commissions paid and shipping expenses as a result of a higher revenue level, an increase in units shipped, the addition of sales and marketing personnel hired to execute on our revenue growth initiatives, such as expansion in Asia, and to support

the continued revenue expansion of our OEM Flash products and our Consumer external storage products in the retail channel. We expect our sales and marketing expenses to increase in absolute dollars as our revenues grow.

General and Administrative. General and administrative expenses are primarily comprised of personnel costs for our executive and administrative employees, professional fees and facilities overhead. General and administrative expenses were $3.6 million in the second quarter of 2006, compared to $3.1 million in the second quarter of 2005. General and administrative expenses as a percentage of revenues were 4.5% in the second quarter of 2006, compared to 4.4% in the second quarter of 2005. The increase in general and administrative expenses in absolute dollars was due primarily to an increase in payroll expense as a result of additional headcount and wage increases.

Research and Development. Research and development expenses are comprised primarily of personnel costs for our engineering and design staff and the cost of prototype supplies. Research and development expenses were $2.2 million in the second quarter of 2006, compared to $1.6 million in the second quarter of 2005. Research and development expenses as a percentage of revenues were 2.8% in the second quarter of 2006, compared to 2.3% in the second quarter of 2005. Research and development expenses increased due primarily to an increase in payroll costs from our expanding global research and development efforts related to our OEM Flash product line.

Interest Income and other, Net. Interest income and other, net was $506,000 in the second quarter of 2006 and $417,000 in the second quarter of 2005. Interest income is comprised of interest earned on our cash, cash equivalents and marketable securities. This increase in interest income resulted primarily from higher interest rates in the second quarter of 2006 compared to the second quarter of 2005.

Provision for Income Taxes. The provision for income taxes increased from $537,000 in the second quarter of 2005 to $2.7 million in the second quarter of 2006. As a percentage of income before provision for income taxes, provision for income taxes increased from 21.7% in the second quarter of 2005 to 37.6% in the second quarter of 2006, due primarily to an income tax audit refund from the California Franchise Tax Board of $235,000 in the second quarter of 2005 and certain research and development tax credits which expired at the end of 2005.

Net Income. Net income was $4.5 million in the second quarter of 2006, compared to $1.9 million in the second quarter of 2005.

Comparison of Six Months Ended June 30, 2006 to Six Months Ended June 30, 2005

Net Revenues. Our revenues were $145.0 million in the first half of 2006, compared to $131.5 million in the same period in 2005. Revenues increased 10.3% in the first half of 2006 due primarily to a 45.5% increase in unit shipments, partially offset by a 25.0% decrease in average sales price, or ASP, from $64 in the first half of 2005 to $48 in the first half of 2006. The decrease in our ASP resulted primarily from a shift in product mix and declining DRAM and Flash component prices. The increase in unit shipments resulted primarily from a 359.4% increase in OEM Flash memory units shipped and a 50.3% increase in Consumer external storage units shipped, partially offset by a 37.7% decrease in Consumer standard DRAM units shipped. OEM Flash product shipments increased from 234,000 units in the first half of 2005 to 1,075,000 units in the first half of 2006. Consumer external storage product shipments increased from 169,000 units in the first half of 2005 to 254,000 units in the first half of 2006.

Our Consumer Division revenues decreased 13.8% from $66.5 million in the first half of 2005 to $57.3 million in the first half of 2006. Consumer Division revenues decreased in the first half of 2006 due primarily to a 15.9% decrease in Consumer Division ASP from $44 in the first half of 2005 to $37 in the first half of 2006, partially offset by a 3.6% increase in Consumer Division unit volume resulting primarily from a 24.7% increase in Flash memory units shipped and a 50.1% increase in external storage units shipped. The decrease in Consumer Division ASP resulted from declines in DRAM and Flash component pricing in the first half of 2006 compared to the first half of 2005.

Our OEM Division revenues increased 34.9% from $65.0 million in the first half of 2005 to $87.7 million in the first half of 2006. The increase in OEM Division revenues was due primarily to a 158.3% increase in OEM Division units shipped, partially offset by a 47.4% decrease in ASP from $116 in the first half of 2005 to $61 in the first half of 2006. The increase in OEM Division unit volume resulted primarily from an increase in Flash memory units shipped from 234,000 units in the first half of 2005 to 1,075,000 units in the first half of 2006. The decrease in our OEM Division ASP resulted primarily from a significant shift in product mix toward lower-ASP, lower-capacity (but higher gross margin), Flash memory products.

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Gross Profit. Our gross profit was $32.4 million in the first half of 2006, compared to $23.8 million in the same period in 2005. Gross profit as a percentage of revenues was 22.3% in the first half of 2006, compared to 18.1% in the same period in of 2005. Gross profit as a percentage of revenue in the first half of 2006 increased due primarily to a shift in product mix toward higher gross profit margin OEM products. Gross profit for our Consumer Division as a percentage of Consumer Division revenues increased slightly from 13.2% in the first half of 2005 to 13.4% in the first half of 2006. Gross profit for our OEM Division as a percentage of OEM Division revenues increased from 23.1% in the first half of 2005 to 28.2% in the first half of 2006. This increase in gross profit as a percentage of revenues for our OEM Division resulted primarily from a shift in product mix and an increase in OEM Flash product gross profit margin from 43.0% in the half of 2005 to 44.1% in the first half of 2006 as we significantly expanded revenues from this product line from $12.1 million in the first half of 2005 compared to $37.2 million in the first half of 2006.

Sales and Marketing. Sales and marketing expenses are primarily comprised of personnel costs and travel expenses for our domestic and international sales and marketing employees, commissions paid to internal salespersons and independent manufacturers representatives, shipping costs and marketing programs. Sales and marketing expenses were $13.0 million in the first half of 2006, compared to $11.4 million in the first half of 2005. Sales and marketing expenses as a percentage of revenue were 9.0% in the first half of 2006, compared to 8.7% in the first half of 2005. The increase in sales and marketing expenses in absolute dollars and as a percentage of revenue was due primarily to an increase in commissions paid and shipping expenses as a result of a higher revenue level, an increase in units shipped and the addition of sales and marketing personnel hired to execute on our revenue growth initiatives, such as expansion in Asia, and to support the continued expansion of our OEM Flash products and our Consumer external storage products in the retail channel. We expect our sales and marketing expenses to increase in absolute dollars as our revenues grow.

General and Administrative. General and administrative expenses are primarily comprised of personnel costs for our executive and administrative employees, professional fees and facilities overhead. General and administrative expenses were $7.2 million in the first half of 2006, compared to $6.2 million in the first half of 2005. General and administrative expenses as a percentage of revenues were 5.0% in the first half of 2006, compared to 4.7% in the first half of 2005. The increase in general and administrative expenses in absolute dollars and as a percentage of revenue was due primarily to an increase in bad debt expense, additional payroll expense and severance costs.

Research and Development. Research and development expenses are comprised primarily of personnel costs for our engineering and design staff and the cost of prototype supplies. Research and development expenses were $4.3 million in the first half of 2006, compared to $2.9 million in the first half of 2005. Research and development expenses as a percentage of revenues were 2.9% in the first half of 2006, compared to 2.2% in the fist half of 2005. Research and development expenses increased due primarily to an increase in payroll costs from our expanding global research and development efforts related to our OEM Flash product line.

Interest Income and other, Net. Interest income and other, net was $981,000 in the first half of 2006 and $852,000 in the first half of 2005. Interest income is comprised of interest earned on our cash, cash equivalents and marketable securities. This increase in interest income resulted primarily from higher interest rates in the first half of 2006 compared to the first half of 2005.

Provision for Income Taxes. The provision for income taxes increased from $1.2 million in the first half of 2005 to $3.3 million in the first half of 2006. As a percentage of income before provision for income taxes, provision for income taxes increased from 28.3% in the first half of 2005 to 36.9% in the first half of 2006, due primarily to an income tax audit refund from the California Franchise Tax Board of $235,000 in the second quarter of 2005 and certain research and development tax credits which expired at the end of 2005.

Net Income. Net income was $5.6 million in the first half of 2006, compared to $3.0 million in the first half of 2005.

Liquidity and Capital Resources

Working Capital, Cash and Marketable Securities

As of June 30, 2006, we had working capital of $117.5 million, including $55.2 million of cash and cash equivalents, compared to working capital of $113.2 million, including $60.0 million of cash and cash equivalents as of December 31, 2005 and working capital of $114.8 million, including $60.5 million of cash and cash equivalents as of June 30, 2005. Current assets were 4.2 times current liabilities at June 30, 2006, compared to 5.1 times current liabilities at December 31, 2005, and 5.9 times current liabilities at June 30, 2005.

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Cash Used in Operating Activities in the Six Months Ended June 30, 2006 and 2005

Net cash used by operating activities was $3.3 million for the six months ended June 30, 2006 and resulted primarily from a $15.4 million increase in accounts receivable, net of allowances, and an $8.7 million increase in inventory, net of reserves, partially offset by, net income of $5.6 million, non-cash depreciation and amortization of $2.0 million, non-cash accounts receivable provisions and inventory obsolescence expense of $3.4 million, a decrease in other assets of $1.1 million, an increase in accounts payable of $7.6 million and a $1.7 million increase in accrued and other liabilities. Accounts receivable, net of allowances, increased primarily due to an increase in sales for the OEM Division Flash product line orders and the continued growth of our external storage product line in the retail channel. Inventory, net of reserves increased due to the increase in sales as noted above, and due to new inventory consignment arrangements at two major retailers. Net cash used in operating activities was $10.6 million for the six months ended June 30, 2005 and resulted primarily from a $13.8 million increase in inventory, net of reserves, and a $3.1 million increase in accounts receivable, net of allowances, partially offset by net income of $3.0 million and a $1.8 million increase in accounts payable. Inventory, net of reserves, increased primarily to support OEM Division orders and the continued growth of our external storage product line in the retail channel.

Cash Used in Investing Activities for the Six Months Ended June 30, 2006 and 2005

Net cash used by investing activities was $3.1 million for the six months ended June 30, 2006, attributable primarily to cash consideration of $500,000 paid for the acquisition of a division of Integrated Circuit Solution Incorporation in January 2006 and $2.6 million in purchases of furniture, fixtures and equipment. Net cash provided by investing activities was $9.2 million for the six months ended June 30, 2005, attributable primarily to $10.0 million of redemptions of marketable securities, partially offset by $834,000 in purchases of furniture, fixtures and equipment.

Cash Provided in Financing Activities for the Six Months Ended June 30, 2006 and 2005

Net cash provided by financing activities was $1.6 million for the six months ended June 30, 2006 and resulted from $1.4 million of proceeds realized from the exercise of stock options and a $242,000 tax benefit from employee stock option exercises. Net cash used by financing activities was $11.4 million for the six months ended June 30, 2005 and resulted primarily from the $11.8 million repurchase of our common stock under our stock buy back plan, partially offset by the issuance of common stock for proceeds of $349,000 related to our employee stock purchase plan and stock option exercises.

We believe that our existing assets, cash, cash equivalents and investments on hand, together with cash that we expect to generate from our operations, will be sufficient to meet our capital needs for at least the next twelve months. However, it is possible that we may need or elect to raise additional funds to fund our activities beyond the next year or to consummate acquisitions of other businesses, products or technologies. We could raise such funds by selling more stock to the public or to selected investors, or by borrowing money. In addition, even though we may not need additional funds, we may still elect to sell additional equity securities or obtain credit facilities for other reasons. We cannot assure you that we will be able to obtain additional funds on commercially favorable terms, or at all. If we raise additional funds by issuing additional equity or convertible debt securities, the ownership percentages of existing shareholders would be reduced. In addition, the equity or debt securities that we issue may have rights, preferences or privileges senior to those of the holders of our common stock.

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

- our relationships with suppliers and customers;
- the market acceptance of our products;
- the levels of promotion and advertising that will be required to launch our new products and achieve and maintain a competitive position in the marketplace;
- expansion of our international business, including the opening of offices and facilities in foreign countries;

price discounts on our products to our customers;

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

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

the levels of inventory and accounts receivable that we maintain;

our entrance into new markets;

capital improvements to new and existing facilities;

technological advances; and

competitors responses to our products.

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Contractual Obligations and Off Balance Sheet Arrangements

Set forth in the table below is our estimate of our significant contractual obligations at June 30, 2006. We do not have off-balance sheet financing arrangements as of June 30, 2006.

		Payment due by period			
		Less than			More than
Contractual Obligation	**Total**	**1 year**	**1-3 years**	**3-5 years**	**5 years**
Operating Lease Obligations	$ 7,551,000	$ 1,061,000	$ 1,575,000	$ 1,266,000	$ 3,649,000
Non-cancelable capital equipment purchase commitments	$ 291,000	$ 291,000	$	$	$
Non-cancelable inventory purchase commitments	$ 25,649,000	$ 25,649,000	$	$	$
Other non-cancelable purchase commitments	$ 1,443,000	$ 1,443,000	$	$	$
Total	$ 34,934,000	$ 28,444,000	$ 1,575,000	$ 1,266,000	$ 3,649,000

Inflation

Inflation was not a material factor in either revenue or operating expenses during each of the first six months ended June 30, 2006 and 2005.

Critical Accounting Policies and Estimates

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

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

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

Product returns. We offer a majority of our customers that purchase products through our consumer channels limited rights to return unsold inventory. In addition, while we may not be contractually obligated to accept returned products, we may determine that it is in our best interest to accept returns in order to maintain good relationships with our customers. We provide for estimated future returns of inventory at the time of sale based on historical experience, and actual results have been within our expectations.

Sales and marketing incentives. Sales and marketing incentives are offset against revenues or charged to operations in accordance with Emerging Issues Task Force Issue No. 01-09 (EITF 01-09), *Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor s Products)* . Sales and marketing incentives amounted to $3.3 million and $2.3 million for each of the three months ended June 30, 2006 and 2005, respectively, of which $3.2 million and $2.1 million, respectively, were offset against revenues, and $121,000 and $184,000, respectively, were charged as an operating expense. Sales and marketing incentives amounted to $6.1 million and $4.5 million for each of the six months ended June 30, 2006 and 2005, respectively,

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of which $6.0 million and $4.2 million, respectively, were offset against revenues, and $131,000 and $340,000, respectively were charged as an operating expense.

Consideration generally given by us to a customer is presumed to be a reduction of selling price, and therefore, a reduction of revenue. However, if we receive an identifiable benefit in return for the consideration given to our customer that is sufficiently separable from our sales to that customer, such that we could have paid an independent company to receive that benefit; and we can reasonably estimate the fair value of that benefit, then the consideration is characterized as an expense. We estimate the fair value of the benefits we receive by tracking the advertising done by our customers on our behalf and calculating the value of that advertising using a comparable rate for similar publications.

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

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

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

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Interest Rate Risk

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

At June 30, 2006, our cash and cash equivalents were $55.2 million invested in money market and other interest bearing accounts.

From time to time, we invest in marketable securities, however, at June 30, 2006, our investment in marketable securities was $0.

If interest rates were to decrease 1%, the result would be an annual decrease in our interest income related to our cash and cash equivalents of approximately $552,000. However, due to the uncertainty of the actions that would be taken and their possible effects, this analysis assumes no such action. Further, this analysis does not consider the effect of the change in the level of overall economic activity that could exist in such an environment.

The carrying amount, principal maturity and estimated fair value of our cash and cash equivalents as of June 30, 2006 were as follows:

Expected Maturity Date Before July&	Total	Fair Value 6/30/2006