

ANNUAL REPORT
2001



DESWELL
DESWELL INDUSTRIES, INC.

ANNUAL REPORT 2001

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PLASTIC INJECTION MOLDING

Using separate shifts, injection molding is conducted 24 hours a day, seven days a week.

versatile...



A person wearing a white lab coat is operating a large, white industrial machine. The machine has a control panel with a small screen and several buttons. The person is holding a stack of papers and appears to be feeding them into the machine. The machine has a large, flat surface where the papers are being processed. The overall scene is set in a clean, professional environment, likely a laboratory or a manufacturing facility.

...and efficient

Deswell is continually adding equipment to expand its mold-making and tooling capabilities.

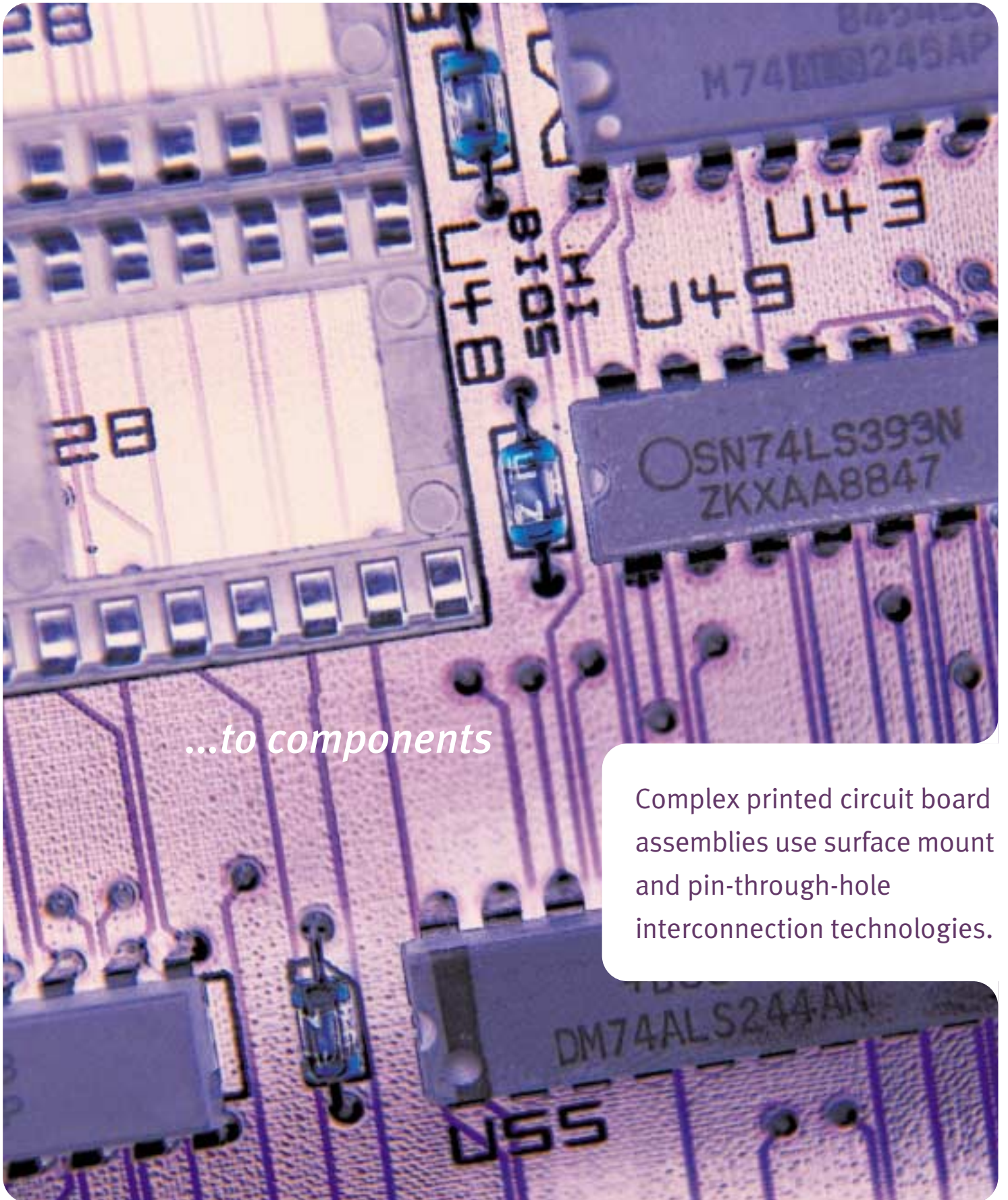
PLASTIC CASES

METAL PARTS MANUFACTURING



from case...

In April 2000, the Company received ISO 9002 for its metal manufacturing operation.



...to components

Complex printed circuit board assemblies use surface mount and pin-through-hole interconnection technologies.

ELECTRONIC PRODUCTS

COMPANY PROFILE

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.





Deswell Industries, Inc. (“Deswell”), 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 (“OEMs”) and contract manufacturers. From its high-quality, low-cost manufacturing bases in the People’s Republic of China (PRC), Deswell produces a wide variety of plastic parts and components used in the manufacture of consumer and industrial products, including

- cases and key tops for calculators and personal organizers;
- cases for flashlights, telephones, paging machines, projectors and alarm clocks;
- grips and rods for fishing tackle; and
- toner cartridges and cases for photocopy machines and printers.

The Company also produces a variety of electronic products, including

- complex printed circuit board assemblies using surface mount and pin-through-hole interconnection technologies;
- special purpose telephones used as private automated branch exchanges, network terminals, and internet phones, for each of which Deswell also manufactures plastic parts;
- telephone answering machines; and
- sophisticated professional audio equipment such as power amplifiers, mixers and digital signal processors, and DVD players.

Several innovative new products have also been created by Deswell’s electronics research and development team: these include full-duplex conference speakerphones, tele-video monitoring systems, and digital color cameras.

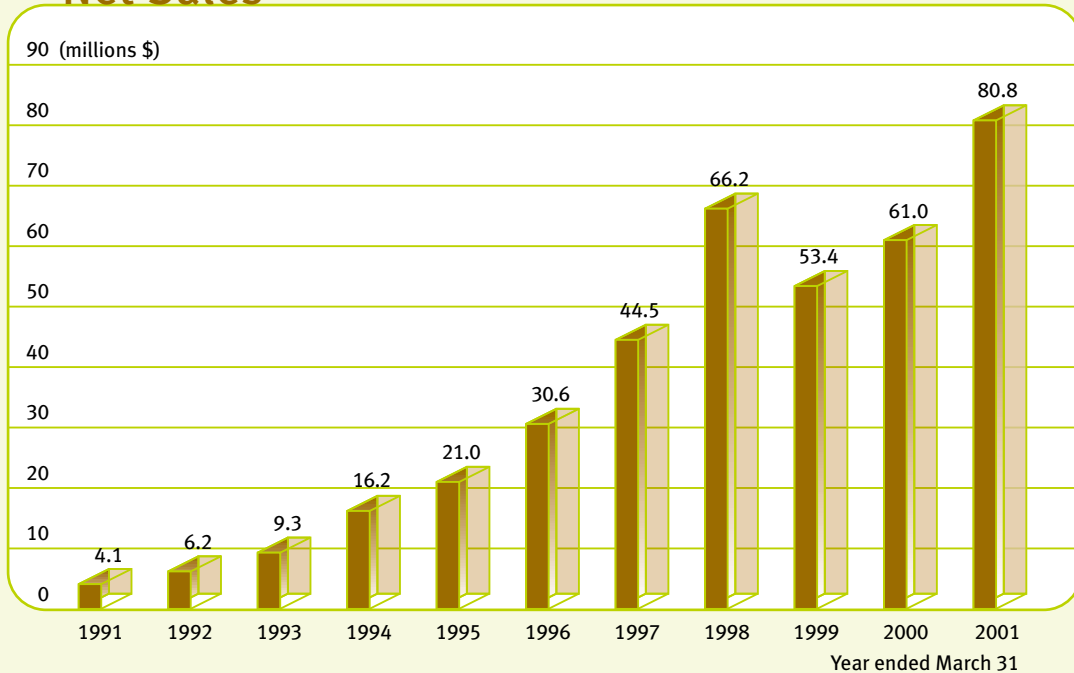
Metal products manufactured by Deswell include metallic molds and accessory parts used in audio equipment, telephones and copying machines and metal racks for telecommunication servers.

At every level of manufacture Deswell insists on close customer consultation, to ensure that customers end up with exactly what they require, manufactured to the highest possible standards. Whether in designing plastic parts and the molds used to manufacture them, or in deciding upon circuit board layout, the Company provides advice and welcomes customer input at every step.

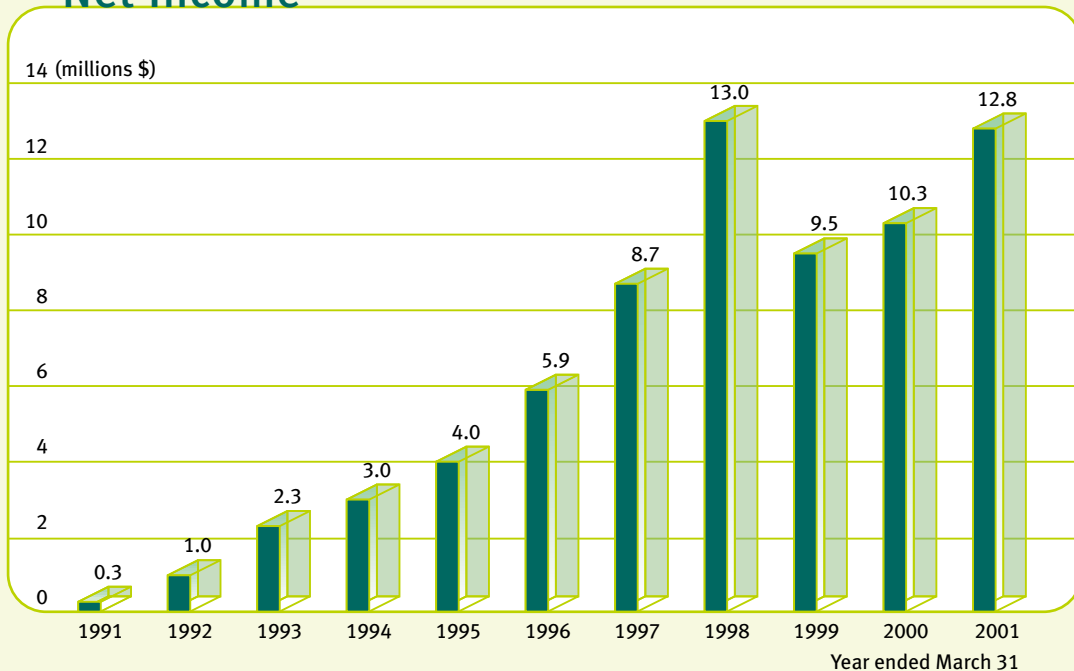
With wide manufacturing capabilities and expertise, innovative R&D teams, and international levels of quality control – all coupled with low production costs – Deswell holds a powerful competitive advantage over most other manufacturers of plastic products, an advantage that the Company is committed to sustaining and developing in the future.

FINANCIAL HIGHLIGHTS

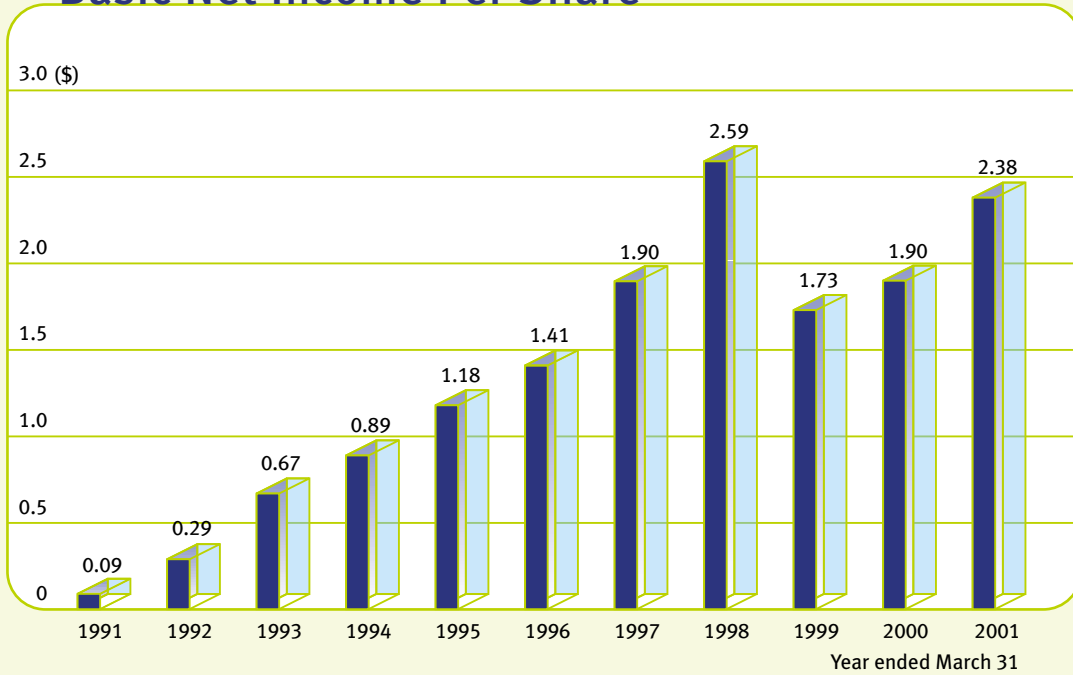
Net Sales



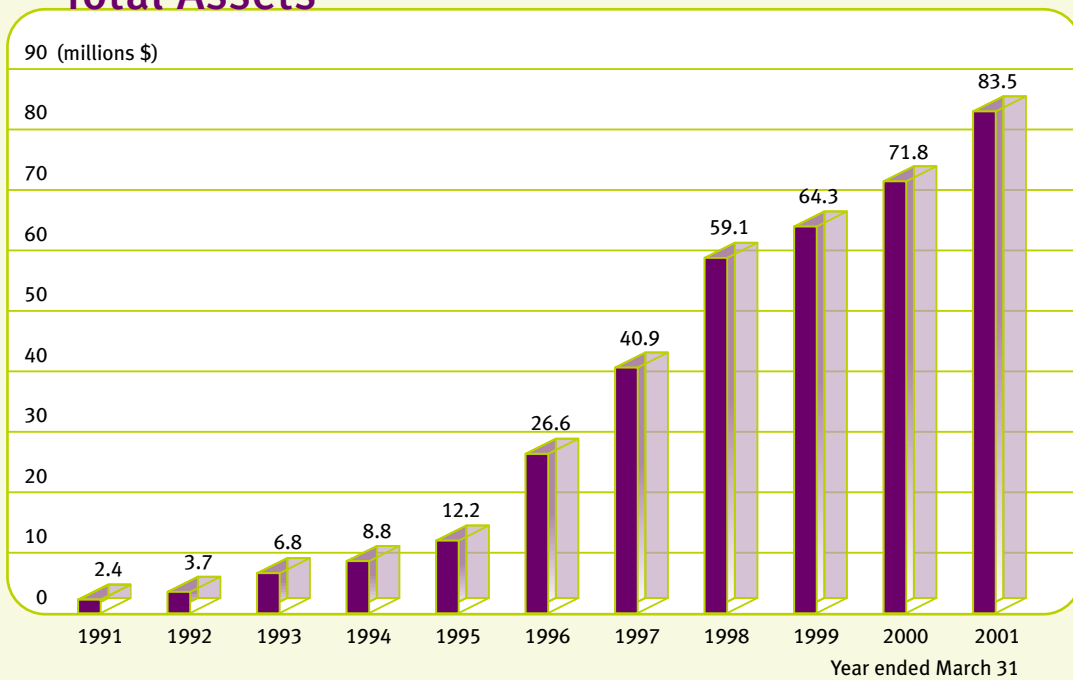
Net Income



Basic Net Income Per Share



Total Assets



We continue to evolve our business to meet the changing needs of our customers and stay ahead of the market.

Dear Shareholder:

For our fiscal 2001 year, I am pleased to report that we made solid progress in our financial performance, while continuing to expand our business for future growth. In doing so, we strengthened our leadership position, and further distinguished ourselves among our competitors. Before we discuss the future, let us discuss our accomplishment over the past year.

Our net sales for the year ended March 31, 2001 were \$80.8 million, an increase of 33% over sales of \$61.0 million for the year ended March 31, 2000. Operating income increased 20% to 12.8 millions, compared to \$10.7 million in the previous year, and net income increased 24% to \$12.8 million, compared to \$10.3 million in the previous year. Basic earnings per share and diluted earnings per share increased to \$2.38 and \$2.36 respectively (based on 5,376,000 and 5,435,000 weighted average shares outstanding, respectively), compared to \$1.90 and \$1.89 respectively (based on 5,412,000 and 5,449,000 weighted average shares outstanding, respectively), for the year ended March 31, 2000.

Given the uncertain global market conditions and the overall slowdown in technology manufacturing, we are pleased to show strong year-over-year growth. This was accomplished by working hard to gain significantly increased business from some existing customers, while adding new customers such as Peavey and Emerson to our growing customer base.

We continue to evolve our business to meet the changing needs of our customers and stay ahead of the market. We leased 1.3 million square feet of land in Dongguan, where construction is underway which will dramatically expand our plastic injection operations. In light of the current economic environment, we are closely monitoring the pace of development to maintain our healthy balance sheet. By ultimately migrating all our plastics operations from Shekou to Dongguan, our annual rental and labor costs could decrease by over \$1.5 million. Over the next five years, we are prepared to triple the capacity of our plastics operations if demand warrants.

Along with our growing infrastructure and additional manufacturing plants, I am pleased to report an overall profit margin of 34.9% for the year. In addition to reporting strong profitability, we continue to have no short-term or long-term debt. As of March 31, 2001, the Company reported \$25.3 million in cash and cash equivalents, compared to \$27.1 million on March 31, 2000. Working capital was \$47.3 million as of March 31, 2001, versus \$44.7 million as of March 31, 2000.

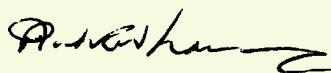
Due to our long-standing healthy balance sheet, the board of directors has declared dividends for five consecutive years. For fiscal 2001, regular cash dividends totaled \$0.90 per share, compared to \$0.88 per share in 2000. Showing an even stronger commitment to our shareholders, we also announced that beginning in the first quarter we will pay dividends on a quarterly basis. The dividend payout will account for approximately 30% to 40% of the net earnings.

With more management control, we generated more profits in both the metallic and electronic subsidiaries, Kwanta Precision Metal Products, Co., Ltd. and Kwanasia Electronics Co., Ltd. Collectively, these divisions recorded a 39% increase in net revenue for the year. We expect greater improvement, beginning in the second quarter of fiscal year 2002, when we commence production of new products. For instance, we anticipate a 70% to 100% increase in sales of audio mixer products alone this year.

I want to take this opportunity to thank our customers and shareholders for their support, and re-emphasize our commitment to reward that support by always striving to achieve the best financial performance possible. Our focus in the coming years is on building out our capacity for our existing and new customers while focusing on cost controls to maximize profitability for shareholders.

Finally, I want to thank the management and staff of Deswell for their continued dedication to the company; it is because of them that Deswell has performed so well over the past years, and it is because of them that we will continue to prosper for years to come.

Sincerely,

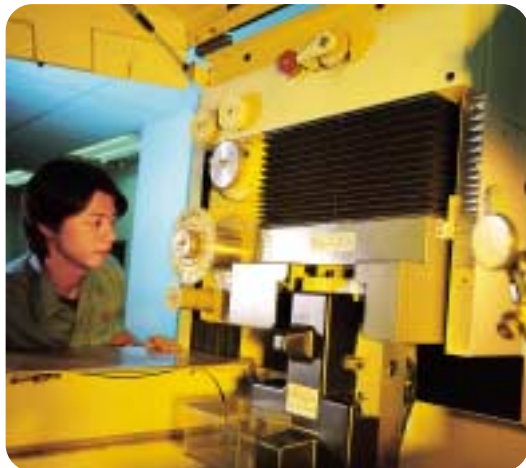


Richard Lau
Chairman and Chief Executive Officer

INDUSTRY OVERVIEW

The Company anticipates a significant increase in opportunities to boost its customer base, as it positions itself to meet the outsourcing requirements of OEMs and contract manufacturers of high-end products.





Increasingly, users of injection molded and metal products now prefer to outsource their parts requirements, a trend which is set to benefit the Company's injection molding operation and its metal molds and parts manufacturing business. As a large, experienced parts producer with an international reputation, Deswell is an obvious choice for many businesses engaged in outsourcing. Other parts manufacturers in China tend to operate on a much smaller scale than Deswell, and are consequently often unable to react quickly and responsively to diverse customer demands, besides being unable to achieve the levels of quality that high-end plastic and metal products require. The Company anticipates a significant increase in opportunities to boost its customer base, as it positions itself to meet the outsourcing requirements of OEMs and contract manufacturers of high-end products.



Precise plastic injection molding parts.



OPERATIONS REVIEW

Plastic Injection Molding

With over half a million square feet of manufacturing space in the Shenzhen Special Economic Zone in the PRC, plastic injection molding accounted for 62.2% of Deswell's total sales in the year ended March 31, 2001 (2000: 62.9%; 1999: 55.9%), and, as the Company's core business, remains the most significant of its manufacturing operations.

The plastic injection molding process consists of three phases: mold design and production, plastic injection, and finishing.



Dust free injection plant.

Mold design and production

In consultation with the Company's technical staff, a customer begins by providing specifications for a product or part, upon which the Company designs and produces a suitable mold. At this stage, extreme care is taken both in design and the selection of materials, since a high quality appearance of the finished product is crucial.



Mold design drawing division.

The mold-making process takes from 30 to 75 days, depending on the size and complexity of the mold. Mold making requires specialized machines and is capital intensive; the Company is continually adding equipment to expand its mold-making and tooling capabilities. Since 1999, the Company has purchased several state of the art manufacturing machines to maintain its high production standards: these include two advanced "Makino" tooling machines, a Graphite CNC Milling Machine and a V55-A15 Vertical Machining Center (\$700,000). These are nearly four times faster than normal machines in certain applications, and generally achieve much higher efficiency in mold making. In addition, the Company has spent over \$1.5 million on

several sets of numerical control (NC) milling machines, electrical discharge machines (EDM), and computer numerical control (CNC) milling machines, and at March 31, 2001 was using 22 EDMs, 23 CNC milling machines and 53 NC milling machines in the mold-making process. With these resources at its disposal, the Company has positioned itself as a major international player in the world of injection molded plastic products.

Molds produced by the Company may weigh anything from 220 to 12,000 pounds, and range in cost between \$3,000 and \$500,000. The customer generally pays for the molds and, as is customary in the industry, owns the finished product. However, the Company maintains and stores the molds at its factory for use in production, and is thus able to use its mold-making expertise to engender a wider customer dependence and reliance.

The Company made on average 60 different molds every month. Its expertise in mold making and its economic PRC-based operations means that the Company can produce molds at costs substantially less than molds of comparable quality made in Japan, Korea and Taiwan.

The Company also offers the latest in sophisticated mold-making technology, with its Insert Mold Decoration (“IMD”) and Film Insert Molding (“FIM”) techniques. This technology, used for high-end audio and telecommunications products, allows the construction of molds enabling silk-screening, multi-coloring and complex graphic designs to be added to plastic products at the injection stage. The Company has built specially designed dust-free injection rooms to operate this technology.

Plastic Injection

During the mold-making process, suitable plastic resin for the product to be manufactured is selected and purchased. The completed molds are then mounted onto injection machines, classified according to their “clamping force” (the pressure per square inch required to hold a mold in place during the injection molding process). At March 31, 2001, the Company had 252 injection molding machines, ranging from 50 to 1,600 tons of clamping force, with most machines in the 80 to 100 ton range. Each of the Company’s machines is capable of servicing a variety of applications and product configurations, including machines which can fabricate plastic parts as small as a button or as large as a 2.5 x 2 foot copy machine case. To maintain maximum efficiency, injection molding machines operate 24 hours a day, seven days a week (other than normal down time for maintenance or changing product molds), ensuring a continuous output.



Wire cut division.

Amongst the Company’s range of injection molding machines are 14 sets of double-injection molding machines, which are capable of simultaneously injecting two different color plastics into a mold. The colors injected are very solid and of exceptionally high quality. These machines are used for the production of brand labels, key caps and buttons for telecommunications products.

OPERATIONS REVIEW

Finishing

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



Advanced “Panaset MVIIF” SMT versatile placement machine.

Electronic Products and Assemblies

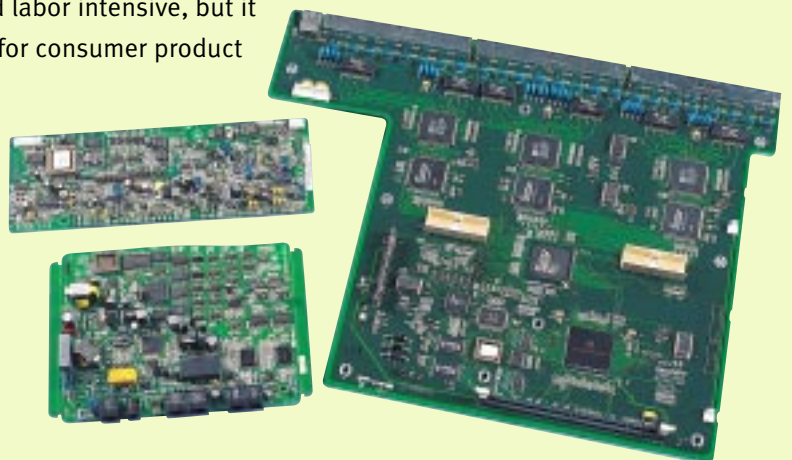
Sophisticated studio-quality audio equipment, telephones and telephone answering machines, computer peripherals such as LAN (local area network) add-in cards, CD-ROM drives and sound cards, electronic toys, infrared remote controls and radar detectors—these are some of the finished products manufactured by Deswell in over 300,000 square feet of factory space in Dongguan, PRC. Assemblies consist of PCBs with mounted components, both passive (e.g. resistors, capacitors, transformers, switches and wire) and active (e.g. semiconductors and memory chips). This area of operations accounted for over a third of the Company’s total sales for the year ended March 31, 2001 (2001: 35.4%; 2000: 30.6%; 1999: 40.7%).

In assembling printed circuit boards the Company purchases packaged boards with the active components already mounted and uses both pin-through-hole (“PTH”) and surface mount technology (“SMT”) interconnection methods to assemble the other components.

PTH is a technology now some years old, and labor intensive, but it still retains a significant market, particularly for consumer product applications. It is a method of assembling printed circuit boards in which component leads are inserted and soldered into plated holes in the board.

SMT is a much more recent assembly method, in which components are fixed directly to the surface of the circuit board, rather than being inserted into holes. In this process, solder is accurately stencilled in paste form onto pads located on the printed circuit board. The components are then

placed into the solder paste and heated to the point of melting the paste to establish a strong solder joint. SMT allows for higher cost savings and shorter lead paths between components (resulting in greater signal speed).



Additionally, it allows components to be placed on both sides of the printed circuit board, enhancing the miniaturization process.

Besides PCB assembly, the Company also performs testing and, in orders for finished products, assembly into final product housing. While the Company has automated many aspects of its manufacturing processes, assembling components into electronic products remains a labor-intensive process requiring a high degree of precision and dexterity at the assembly stage, and multiple quality control checks prior to shipment. Specially designed equipment maximizes the Company's ability to assemble efficiently a wide variety of electronic products, and staff expertise coupled with stringent quality control checking procedures ensures a minimum of human error.

Metal Parts Manufacturing

A minor area of Deswell's manufacturing output remains the manufacture of metallic molds and metal accessory parts for use in audio equipment, telephones and copying machines. Sales currently stand at below three per cent of total sales for the company (2001: 2.4%; 2000: 6.5%; 1999: 3.4%).



Metal CNC machine.

OPERATIONS REVIEW

Quality Control

The Company is committed to the highest possible quality standards for all its products and manufacturing processes, and maintains strict quality control procedures, carrying out hourly checks on machines and molds to ensure that plastic parts are free from defects. If defects are discovered, maintenance personnel determine whether mold or machine is responsible, and the cause of the defect is immediately serviced and repaired. Due to this continuous vigilance, the Company has enjoyed a low scrap rate and has been able to maintain a high level of productivity from its injection molding machines. Such quality assurance is vital for maintaining the Company's international reputation as a major high-end parts and equipment manufacturer.



Central monitor system workshop.

Molding of products requiring extra concern for appearance (such as cases for calculators, personal organizers and telephones) is conducted in a separate, dust free section of the factory to lower risks of defects even further.

Electronic operations require even more stringent quality control measures, including checks on all incoming components, on all work in process at several points in the production process, and, randomly, on finished products. These checks conform to international standards, and include tests and surveys such as the IPC610 Class II workmanship standard, QC on line with 100% full inspection, pre-test fixture fabricated in house, in-circuit test, complete product functional test and MIL-STD-1050 Class II QA sampling plan.

Overall, Deswell's advanced quality control systems have meant that plastic, electronic and metal products manufactured and assembled at the Company's facilities have maintained a very low level of product defects, with aggregate returns representing less than 3% of total net sales across the three years ended March 31, 2001.

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

The Company is also currently working towards obtaining QS-9000 qualifications. QS-9000 is an internationally recognized set of quality systems 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 2002.

Raw Materials, Component Parts and Suppliers

Plastic Resins

The Company uses various plastic resins in the manufacture of its plastic parts, and currently obtains these from suppliers in Hong Kong, Japan and Taiwan. Because plastic resins are commodity products, the Company selects its suppliers primarily based on price, and has no long-term supply agreements; it normally maintains a three to four month inventory supply. In the last financial year, the cost of plastic resin averaged 58% of the cost of plastic products sold (2000: 55%; 1999: 50%), and as a percentage of the total cost of goods sold in the same year it averaged 32% (2000: 31%; 1999: 24%).

Because the Company makes high volume purchases of plastic resins (using over 16,700,000 pounds in the year ended March 31, 2001), it has benefited from lower unit raw material costs and regular problem-free shipments.

Although the plastics industry experiences shortages of plastic resins from time to time, the Company has not to date encountered any such problems, and currently 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 in Japan, Taiwan, Korea, Hong Kong and elsewhere, and is not dependent upon a single supplier for any essential component. Shortage of electronics component parts such as PCBs and semiconductors is an occasional problem, but this has not had a material adverse effect on the Company's results or operations to date.

Raw Metal

The Company uses various metals in its metal molds and parts manufacturing, but purchases of raw metal were insignificant in terms of the Company's total recent operations. The Company buys metals from a variety of suppliers in Hong Kong and China and has no long-term contracts with metal suppliers.

OPERATIONS REVIEW

Customers and Marketing

The Company has an international customer base of OEMs and contract manufacturers, located in Asia (Hong Kong, Japan and China), North America (the United States and Canada) and Europe (Germany, United Kingdom, France and Italy). Net sales as a percentage of total sales to customers by geographic area (based on customer shipping destinations) over the past three years were as follows:

Geographic areas

	1999	2000	2001
China	32.5%	42.6%	54.5%
North America	24.4%	27.0%	22.6%
Hong Kong	25.9%	24.1%	19.2%
Europe	15.9%	5.1%	2.2%
Japan	1.3%	1.2%	1.0%
Others	–	–	0.5%
Total	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>

Deswell's management and direct sales personnel market its products and services to existing customers. The Company uses the full range of sales methods available, attending trade shows, advertising in major trade publications and utilizing direct mail catalogues and product literature, as well as targeting potential customers using diverse media.

Sales transactions with customers are based on purchase orders received, and apart from these purchase orders the Company has no written agreements with its customers. Sales of plastic parts and metallic products are usually made on credit terms, with payment in Hong Kong dollars expected within 30 to 60 days of shipment, while sales of electronic products are typically based on letters of credit and are payable in United States dollars.

The Company has maintained a good record in collecting accounts receivable on credit sales, due to its policies of communicating regularly with credit sale customers and closely monitoring the status of payment. Additionally, plastic parts deliveries are often made in several instalments over a lengthy period of time, allowing the Company to withhold delivery in cases of non-payment.

Property, Plant and Equipment

The Company both owns and leases various properties in Hong Kong and the PRC for administrative and manufacturing purposes. The details of these arrangements, as at March 31 2001, are laid out below.

Hong Kong

- Units 514-517 and 602 Hong Leong Industrial Complex, 4 Wang Kwong Road, Kowloon Bay, Hong Kong
- Units 10-14, 19/F., Kwong Sang Hong Centre, 151-153 Hoi Bun Road, Kwun Tong, Hong Kong

Size	Purpose	Status
3,800 sq. ft.	Administration office of plastic injection molding operations	Owned
1,150 sq. ft.	Administration office of plastic injection molding operations	Leased
3,650 sq. ft.	Warehouse for plastic injection molding operations	Leased
6,150 sq. ft.	Administration and marketing offices for contract electronic and metal manufacturing operations	Owned

Southern China

- Wing Village Industrial Estate,
Shekou, Shenzhen, PRC
 - Block A, 1/F-2/F;
 - Block B, 1/F-3/F;
 - Block C, 1/F-2/F;
 - Block D, 1/F-5/F;
 - Block E, 2/F-5/F;
 - Block F, 1/F-5/F;
 - Block G, 1/F-5/F;
 - Block H, 2/F-5/F
- Huangguan Industrial Estate, Houjie Town, Dongguan , Shenzhen, PRC
- Kwan Hong Building, Cheung On, Dongguan, Shenzhen, PRC
- Nan Tau Building, Nanshan, Shenzhen, PRC
- Lan Wang Building, Cheung On, Dongguan, Shenzhen, PRC
- Kwanta Building, Cheung On, Dongguan, Shenzhen, PRC

OPERATIONS REVIEW

Address	Purpose	Status	Size (sq.ft.)
Block G, Wing Village Industrial Estate	Factory of plastic injection molding operations	Owned	112,900
Block A–F & H, various floors, Wing Village Industrial Estate	Factory of plastic injection molding operations	Leased	300,700
Huangguan Industrial Estate	<ul style="list-style-type: none"> • Factory I of plastic injection molding operations • Dormitory 	Leased	56,800 37,100
Huangguan Industrial Estate	<ul style="list-style-type: none"> • Factory II of plastic injection molding operations • Dormitory 	Leased	58,100 22,400
Various locations in Shekou	Dormitory accommodation	Leased	96,200
Various locations in Dongguan	Dormitory accommodation	Leased	28,900
Various locations in Shenzhen	Dormitory accommodation	Owned	24,600
Kwan Hong Building	<ul style="list-style-type: none"> • Factory of contract electronic manufacturing operations • Dormitory for contract electronic and metal manufacturing operations 	Leased	264,200 133,300
Nan Tau Building	Office for contract electronic manufacturing operations	Leased	2,100
Lan Wang Building	<ul style="list-style-type: none"> • Factory of contract electronic manufacturing and metal manufacturing operations • Dormitory for contract metal manufacturing operation 	Leased	96,000 38,300
Kwanta Building	Factory of contract metal manufacturing operation	Leased	69,500
Various locations in Dongguan and Shenzhen	Staff quarters	Leased	150,500

Capital Expenditures

Principal capital expenditures and divestitures made by Deswell during the three years ended March 31, 2001 are as follows:

	<u>1999</u>	<u>2000</u>	<u>2001</u>
Purchase of property, plant and equipment	\$ 4,282,000	\$ 6,019,000	\$ 13,926,000
Proceeds from the sale of property, plant and equipment	18,000	176,000	113,000

Principal capital expenditures currently in progress relate to improvements being made on land purchased in Dongguan, China to build a new factory. The construction of the new Dongguan factory and dormitories will consist of three to four phases, with the pace of development depending on the Company's financial situation and future operating results. Management estimates that the first phase of construction will cost approximately \$11 million, with construction beginning in September or October 2001 and expected to take eight months. Barring unforeseen delays, the new factory built from the Phase I portion of the project is expected to commence operations in late 2002.

These capital expenditures continue to be financed mainly from internally generated funds.

MANAGEMENT DISCUSSION AND ANALYSIS

Year ended March 31, 2001 Compared to Year Ended March 31, 2000

The Company's net sales for the year ended March 31, 2001 ("2001") were \$80,847,000, an increase of \$19,889,000 (32.6%) over the year ended March 31, 2000 ("2000"). Sales to Inter-Tel Incorporated ("Inter-Tel"), Kyocera Mita Industrial Co. (H.K.) Ltd. ("Mita"), VTech Communications Ltd. ("VTech") and Epson Precision (H.K.) Ltd. ("Epson"), the Company's four largest customers during 2001, represented 69.3% of net sales for the year.

The overall increase mainly resulted from improved sales of injection-molded plastic products (an increase of \$10,996,000 or 28.7% over the previous year) and electronic and metallic products (an increase of \$8,893,000 or 39.3%).

By geographical analysis based on customer shipping destinations, sales to all areas except Europe rose over the past year. These included an \$18,120,000 increase in sales to China, along with increases to North America (\$1,795,000), Hong Kong (\$852,000), Japan (\$14,000), and other areas (\$400,000). In the European market, sales decreased by \$1,293,000 by comparison with the previous year.

The overall gross profit for 2001 was \$28,251,000, representing a gross profit margin of 34.9%. This compares with the overall gross profit and gross profit margin of \$22,696,000 and 37.2% for the previous year. The absolute decrease in the overall gross profit margin (2.3%), and the percentage decrease (6.2%), was the result of higher resin costs and electronics component costs in the plastic and electronic divisions.

Selling, general and administrative expenses for the year under review were \$15,414,000 or 19.1% of total net sales, as compared to \$11,970,000 (19.6%) for the previous year. This decline was the result of spreading these expenses over increased sales during 2001.

As a result, operating income was \$12,837,000 for 2001, an increase of \$2,111,000 (19.7%) over the previous year.

Minority interests (a 49% minority interest in both the electronics and metallic subsidiaries) increased to \$621,000 for 2001 from \$433,000 in the previous year, reflecting the fact that the electronic and metallic businesses generated more profits in 2001 than 2000.

Taking the above factors into account, net income was \$12,810,000 for 2001, an increase of \$2,512,000 (24.4%) over the previous year. Net income as a percentage of net sales decreased to 15.8% from 16.9%.

Year ended March 31, 2000 Compared to Year Ended March 31, 1999

The Company's net sales for the year ended March 31, 2000 ("2000") were \$60,958,000, an increase of \$7,519,000 (14.1%) as compared to year ended March 31, 1999 ("1999"). Sales to Inter-Tel, Mita and VTech, the Company's three largest customers during 2000, represented approximately 71.4% of net sales for the year.

The overall sales increase mainly resulted from an increase in sales of injection-molded plastic products of \$8,250,000, offset by a decrease in sales of electronic and metallic products of \$731,000. This represented an increase of 27.4% and a decrease of 3.1% respectively, compared with the net sales of such products in the previous year. The decrease in net sales of electronic and metallic products was the result of a general decrease in demand, especially from customers that subcontracted for PCB product assembly, coupled with reduction in selling prices in both OEM and subcontracted sales.

During 2000, sales to most destinations increased, including those to China (by \$8,667,000), North America (by \$3,415,000), Hong Kong (by \$848,000) and Japan (by \$65,000). Sales to Europe, however, decreased by \$5,476,000 over 1999 levels.

Overall gross profit for 2000 was \$22,696,000, representing a gross profit margin of 37.2%. This compares with the overall gross profit and gross profit margin of \$21,260,000 (39.8%) for 1999. The 2.6% decrease in gross margin of was mainly attributable to a reduction in selling prices for both OEM and subcontracted sales as a result of intense market competition.

Selling, general and administrative expenses for 2000 were \$11,970,000, amounting to 19.6% of total net sales, as compared to \$10,364,000 (19.4%) of total net sales for the previous year. The increase in selling, general and administrative expenses of \$1,606,000 over 1999 was the result of improved business.

Operating income was thus \$10,726,000 for 2000, a decrease of \$170,000 (1.6%) as compared with the previous year.

During 2000, the Company acquired an additional 17.9% equity interest in its metal manufacturing subsidiary. As a result, minority interests represent the Company's 49% minority interest in both the electronics and metallic subsidiaries. The decrease in minority interest to \$433,000 for 2000 from \$1,575,000 for the previous year reflects the fact that electronic and metallic businesses profits were lower in 2000.

Taking the above factors into account, net income was \$10,298,000 in 2000, an increase of \$806,000 (8.5%) compared to 1999, and net income as a percentage of net sales decreased to 16.9% from 17.8%.

MANAGEMENT DISCUSSION AND ANALYSIS

Seasonality

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, manufacturing facilities are closed for two weeks for the Chinese New Year holidays. This seasonality is masked, in part, by steady growth in the Company's operations. The Company does not experience any other significant seasonal fluctuations.

Liquidity and Capital Resources

For the year ended March 31, 2001, net cash generated from operations totalled \$13,810,000, including net income of \$12,810,000 and depreciation and amortization of \$5,039,000. Accounts receivable and inventories increased by \$5,170,000 and \$1,102,000, respectively, over levels a year earlier, primarily as a result of a general increase in sales and business activities. Accounts payable decreased by \$1,127,000 from March 31, 2000.

For the year ended March 31, 2000, net cash generated from operations totalled \$11,236,000, including net income of \$10,298,000 and depreciation and amortization of \$4,784,000. Accounts receivable and inventories increased by \$2,811,000 and \$5,030,000, respectively, over levels at March 31, 1999, while accounts payable increased by \$2,528,000.

In February 2001, Messrs. Richard Lau, C.P. Li and C.W. Leung, the Company's senior executive officers, members of its board and principal shareholders, exercised options for a total of 240,000 common shares of the Company. Proceeds to Deswell totalled \$2,585,100.

Net cash used for investment activities amounted to \$13,672,000 for the year ended March 31, 2001 (2000: \$5,602,000). Capital expenditures during the same period totalled \$13,926,000 (2000: \$6,019,000), financed by cash generated from operations. Capital expenditure was primarily used to acquire plant and machinery for the Company's production facilities in China, and office equipment for the Company's administrative operations there. In addition, \$126,000 was released as security for short-term borrowing facilities, and \$15,000 was released as deposit for customs duty in Dongguan, PRC.

Net cash used in financing activities for the year ended March 31, 2001 was \$1,964,000 (2000: \$6,034,000). This was used primarily to fund the Company's dividend payments to its shareholders netting off the proceeds of \$2,746,000 from the exercise of stock options from directors and employee. The net cash used in financial activities during the previous year was also used primarily to fund the Company's dividend payments to its shareholders, as well as for the repurchase of common stock by the Company, involving repurchase of 128,200 shares for an aggregate of \$1,257,000.

The Company generates sufficient funds from its operating activities to finance its operations and there is no current need for external financing. At March 31, 2001 the Company had no outstanding short-term borrowings or long-term debt.

The fixed exchange rate between the Hong Kong dollar and the US dollar means that interest rates on Hong Kong dollar borrowings are similar to US interest rates. The Hong Kong Prime Rate fluctuated during the year ended March 31, 2001, increasing from 9% at the beginning of the year to 9.5% and then decreasing to 8%.

At March 31, 2001, the Company had cash and cash equivalents of \$25,330,000 and committed credit facilities of \$17,097,000, none of which had been used. The Company also had restricted cash of \$1,988,000 and leasehold land and buildings of \$1,378,000, which were pledged as collateral for those credit facilities, and \$162,000 pledged as deposit for customs duty in Dongguan, PRC. Management 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 plant and machinery of \$375,000 as of March 31, 2001, and expects that internally generated funds will be sufficient to satisfy its cash needs for at least the next 12 months.

FIVE YEAR FINANCIAL SUMMARY

Income Statement Data	Year ended March 31,				
	(In thousands, except per share and percentage data)				
	1997	1998	1999	2000	2001
Net sales	\$44,540	\$66,169	\$53,439	\$60,958	\$ 80,847
Cost of sales	25,465	36,246	32,179	38,262	52,596
Gross profit	19,075	29,923	21,260	22,696	28,251
Selling, general and administrative expenses	7,943	14,067	10,364	11,970	15,414
Operating income	11,132	15,856	10,896	10,726	12,837
Interest expense	(49)	(2)	(306)	(3)	(6)
Other income, net	355	1,094	939	898	915
Income before income taxes	11,438	16,948	11,529	11,621	13,746
Income taxes	528	688	462	890	315
Income before minority interests	10,910	16,260	11,067	10,731	13,431
Minority interests	2,165	3,289	1,575	433	621
Net income	\$8,745	\$12,971	\$9,492	\$10,298	\$12,810
Basic net income per share (2)	\$1.90	\$2.59	\$1.73	\$1.90	\$2.38
Average number of shares outstanding-basic (2)	4,610	5,006	5,478	5,412	5,376
Diluted net income per share	\$1.85	\$2.40	\$1.72	\$1.89	\$2.36
Average number of shares outstanding-diluted (2)	4,737	5,394	5,524	5,449	5,435
Statistical Data					
Gross margin	42.8%	45.2%	39.8%	37.2%	34.9%
Operating margin	25.0%	24.0%	20.4%	17.6%	15.9%
Dividends per share	\$0.60	\$0.70	\$1.08	\$0.88	\$0.88
Balance Sheet Data					
	1997	1998	1999	2000	2001
Working capital	\$21,375	\$35,968	\$41,066	\$44,727	\$47,356
Total assets	40,879	59,144	64,273	71,841	83,466
Long-term debt, less current portion	-	-	-	-	-
Total debt	-	-	-	-	-
Shareholders' equity	29,467	45,211	48,767	53,031	63,877

(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.

(2) In February 1997, the Financial Accounting Standards Board ("FASB") issued SFAS No. 128, "Earnings Per Share," effective for financial statements issued after December 15, 1997. SFAS No. 128 requires that presentation of "Basic" and "Diluted" EPS by entities with complex capital structures, replacing "Primary" and "Fully Diluted" EPS under APB Opinion No. 15. Basic EPS excludes dilution from potential common shares and is computed by dividing income available to common stockholders by the weighted-average number of common shares outstanding for the period. Diluted EPS reflects the potential dilution from potential common shares, similar to fully diluted EPS, but uses only the average stock price during the period as part of the computation. The Company adopted the new method of reporting EPS for the year ended March 31, 1998 and the financial statement for the year ended March 31, 1997 has been restated to reflect the change.

INDEPENDENT AUDITORS' REPORT

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 as of March 31, 2000 and 2001, and the related consolidated statements of income, shareholders' equity and cash flows for each of the three years in the period ended March 31, 2001. 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 auditing standards generally accepted in the United States of America. 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, such consolidated financial statements present fairly, in all material respects, the financial position of Deswell Industries, Inc. and subsidiaries at March 31, 2000 and 2001, and the results of their operations and their cash flows for each of the three years in the period ended March 31, 2001 in conformity with accounting principles generally accepted in the United States of America.

Deloitte Touche Tohmatsu

DELOITTE TOUCHE TOHMATSU

June 30, 2001
Hong Kong

CONSOLIDATED BALANCE SHEETS

(U.S. dollars in thousands, except par value)

	2000	March 31, 2001
ASSETS		
Current assets:		
Cash and cash equivalents	\$27,156	\$25,330
Restricted cash (note 6)	2,129	1,988
Marketable securities (note 3)	1,308	-
Accounts receivable - net of allowance for doubtful accounts of 2000 - \$87 and 2001 - nil	10,607	15,777
Inventories (note 4)	10,932	12,034
Prepaid expenses and other current assets	2,295	1,833
Income taxes receivable	164	428
Total current assets	54,591	57,390
Property, plant and equipment-net (note 5)	16,701	25,563
Goodwill - net of accumulated amortization of 2000 - \$142 and 2001 - \$177	549	513
Total assets	<u>\$71,841</u>	<u>\$83,466</u>
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$5,401	\$4,274
Accrued payroll and employee benefits	1,417	1,837
Customer deposits	1,745	1,850
Other accrued liabilities	1,200	1,776
Income taxes payable	101	297
Total current liabilities	9,864	10,034
Deferred income taxes (note 7)	15	15
Commitments and contingencies (note 9)		
Minority interests	8,931	9,540
Shareholders' equity:		
Common Shares \$0.01 par value-authorized 20,000,000 shares, shares issued and outstanding March 31, 2000 - 5,347,931; March 31, 2001 - 5,597,931	53	56
Additional paid-in capital	24,100	26,843
Retained earnings	28,878	36,978
Total shareholders' equity	53,031	63,877
Total liabilities and shareholders' equity	<u>\$71,841</u>	<u>\$83,466</u>

See accompanying notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF INCOME

(In thousands, except per share data)

	Year ended March 31,		
	1999	2000	2001
Net sales	\$53,439	\$60,958	\$80,847
Cost of sales	32,179	38,262	52,596
Gross profit	21,260	22,696	28,251
Selling, general and administrative expenses	10,364	11,970	15,414
Operating income	10,896	10,726	12,837
Interest expense	(306)	(3)	(6)
Other income, net	939	898	915
Income before income taxes and minority interests	11,529	11,621	13,746
Income taxes (note 7)	462	890	315
Income before minority interests	11,067	10,731	13,431
Minority interests	1,575	433	621
Net income	\$9,492	\$10,298	\$12,810
Net income per share (note 2)			
Basic:			
Net income per share	\$1.73	\$1.90	\$2.38
Weighted average common shares outstanding	5,478	5,412	5,376
Diluted:			
Net income per share	\$1.72	\$1.89	\$2.36
Weighted average common and potential common shares	5,524	5,449	5,435

See accompanying notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

(U.S. dollars in thousands, except per share data)

	<u>Common stock</u>		Additional paid-in capital	Retained earnings	Shareholders' equity
	Shares outstanding	Amount			
Balance at April 1, 1998	5,479,131	\$55	\$25,374	\$19,782	\$45,211
Repurchase and cancellation of common stock	(3,000)	–	(19)	–	(19)
Net income	–	–	–	9,492	9,492
Dividends (\$1.08 per share)	–	–	–	(5,917)	(5,917)
Balance at March 31, 1999	5,476,131	55	25,355	23,357	48,767
Repurchase and cancellation of common stock	(128,200)	(2)	(1,255)	–	(1,257)
Net income	–	–	–	10,298	10,298
Dividends (\$0.88 per share)	–	–	–	(4,777)	(4,777)
Balance at March 31, 2000	5,347,931	53	24,100	28,878	53,031
Exercise of stock options	250,000	3	2,743	–	2,746
Net income	–	–	–	12,810	12,810
Dividends (\$0.88 per share)	–	–	–	(4,710)	(4,710)
Balance at March 31, 2001	5,597,931	\$56	\$26,843	\$36,978	\$63,877

The comprehensive income of the Company for the years ended March 31, 1999, 2000 and 2001 was represented by the net income of the respective year.

See accompanying notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(U.S. dollars in thousands)

	Year ended March 31,		
	1999	2000	2001
Cash flows from operating activities			
Net income	\$ 9,492	\$ 10,298	\$12,810
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	4,223	4,784	5,039
Loss (gain) on sale of property, plant and equipment	14	35	(52)
Minority interests	1,575	433	609
Changes in operating assets and liabilities:			
Accounts receivable	2,283	(2,811)	(5,170)
Marketable securities	(134)	(1,174)	1,308
Inventories	513	(5,030)	(1,102)
Prepaid expenses and other current assets	(2,482)	1,815	462
Income taxes receivable	(179)	233	(264)
Accounts payable	(890)	2,528	(1,127)
Accrued payroll and employee benefits	107	67	420
Customer deposits	932	(420)	105
Other accrued liabilities	(76)	577	576
Income taxes payable	(75)	(99)	196
Net cash provided by operating activities	15,303	11,236	13,810
Cash flows from investing activities			
Purchase of property, plant and equipment	(4,282)	(6,019)	(13,926)
Proceeds from sale of property, plant and equipment	18	176	113
Additional interest in a subsidiary (note 2)	–	(6)	–
Decrease in restricted cash	551	247	141
Net cash used in investing activities	(3,713)	(5,602)	(13,672)
Cash flows from financing activities			
Dividends paid	(5,917)	(4,777)	(4,710)
Repurchase of common stock	(19)	(1,257)	–
Issue of common stock	–	–	2,746
Net cash used in financing activities	(5,936)	(6,034)	(1,964)
Net increase (decrease) in cash and cash equivalents	5,654	(400)	(1,826)
Cash and cash equivalents, beginning of year	21,902	27,556	27,156
Cash and cash equivalents, end of year	\$27,556	27,156	25,330
Supplementary disclosures of cash flow information:			
Additional interest in a subsidiary:			
Goodwill	\$ –	\$ 224	\$ –
Minority interests	–	(218)	–
Cash paid	\$ –	\$ 6	\$ –
Cash paid during the year for:			
Interest	\$ 306	\$ 3	\$ 6
Income taxes	\$ 717	\$ 756	\$ 383

See accompanying notes to consolidated financial statements.

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 and metallic parts and of electronic products and subassemblies. The selling and administrative activities are performed in the Hong Kong Special Administrative Region (“Hong Kong”) of the People’s Republic of China (“China”) and the manufacturing activities are subcontracted to subsidiaries operating in China.

The financial statements of the Company have been prepared in accordance with accounting principles generally accepted in the United States of America (“U.S. GAAP”), which differ from those used in the statutory accounts of its subsidiaries. The principal adjustments made by the Company to conform the statutory accounts of the subsidiaries to U.S. GAAP relate to the recording of dividends only at the time of their declaration and the capitalization of goodwill. 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, 2001, the retained earnings available for distribution as reflected in the statutory books of the subsidiaries were \$60,297, of which \$1,635 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 7).

2. Summary of Significant Accounting Policies

Principles of consolidation – The consolidated financial statements include the assets, liabilities, revenues and expenses of all subsidiaries. Intercompany balances and transactions 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 and is amortized to expense on a straight line basis over 20 years. Amortization expense was \$24 and \$32 and \$36 for the years ended March 31, 1999, 2000 and 2001, respectively.

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.

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 is 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 - 5 years
Furniture, fixtures and equipment	4 - 5 years
Motor vehicles	3 - 4 years
Leasehold improvements	over the term of the lease

Valuation of long-lived assets – The Company periodically evaluates the carrying value of long-lived assets to be held and used, including goodwill and other intangible assets, 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.

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 the subsidiary 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, whose exchange rate 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.

2. Summary of Significant Accounting Policies (Continued)

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.

The Company's operations in China are integrated with the Company and the majority of their transactions are in Hong Kong dollars. Therefore, the Company's China operations use the Hong Kong dollar as their functional currency and all translation adjustments resulting from the conversion of the financial statements of the Company's China operations to Hong Kong dollars are included in income.

Aggregate net foreign currency transaction losses included in income were \$423, \$465 and \$644 for the years ended March 31, 1999, 2000 and 2001, 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 Statement of Financial Accounting Standards (SFAS) No. 52, "Foreign Currency Translation". Accordingly all assets and liabilities are translated at the exchange rate prevailing at the balance sheet date 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, 1999, 2000 and 2001 were HK\$7.74 to US\$1.00, HK\$7.74 to US\$1.00 and HK\$7.75 to US\$1.00, respectively.

Post-retirement and post-employment benefits – The Company does not provide post-retirement benefits, other than pensions, and post-employment benefits are not material.

Stock-based compensation – The Company accounts for stock-based awards to employees using the intrinsic value method in accordance with Accounting Principles Board ("APB") No. 25 "Accounting for Stock Issued to Employees".

Net income per share – Basic net income per share is computed by dividing income available to common holders 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 exercise of warrants and 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):

	Year ended March 31,		
	1999	2000	2001
Net income	\$9,492	\$10,298	\$12,810
Basic net income per share	\$1.73	\$1.90	\$2.38
Basic weighted average common shares outstanding	5,478	5,412	5,376
Effect of dilutive securities - Options	46	37	59
Diluted weighted average common and potential common shares outstanding	5,524	5,449	5,435
Diluted net income per share	\$1.72	\$1.89	\$2.36

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.

Recent changes in accounting standards – In June 1998, the Financial Accounting Standards Board (“FASB”) has issued a new standard Statement of Financial Accounting Standards (“SFAS”) No. 133 “Derivative Instruments and Hedging Activities”. SFAS No. 133, as amended, will be effective for fiscal years beginning after June 15, 2000. Management has completed the analysis of the impact and concluded that there was no significant effect on the consolidated financial statements of the Company on adoption of SFAS No. 133 on April 1, 2001.

In March 2000, the FASB has issued an interpretation (“FIN”) No. 44 “Accounting for Certain Transactions Involving Stock Compensation, an interpretation of APB Opinion No. 25”. FIN No. 44 is effective on July 1, 2000 and there was no significant impact on the consolidated financial statements of the Company on adoption of FIN No. 44.

In June 2001, the FASB has issued two new standards SFAS No. 141 “Business Combinations” and SFAS No. 142 “Goodwill and Other Intangible Assets”. SFAS Nos. 141 and 142 will be effective for the Company’s fiscal year ending March 31, 2003. Management has not yet completed the analysis of the impact these would have on the financial statements of the Company.

3. Marketable Securities

The Company acquired equity securities listed in United States of America.

	2000	March 31, 2001
Cost	\$1,072	\$ -
Unrealized gain	236	-
Market value	<u>\$1,308</u>	<u>\$ -</u>

Net proceeds from sale of marketable securities for the year ended March 31, 2000 and 2001 were \$133 and \$1,419, and realized (loss) and gain from sale of marketable securities for the year ended March 31, 2000 and 2001 were \$(1) and \$111, respectively. For the purposes of determining realized gains and losses, the cost of securities sold was determined based on the average cost method.

4. Inventories

Inventories by major categories are summarized as follows:

	2000	March 31, 2001
Raw materials	\$6,924	\$6,130
Work in progress	1,553	2,946
Finished goods	2,455	2,958
	<u>\$10,932</u>	<u>\$12,034</u>

5. Property, Plant and Equipment

Property, plant and equipment consists of the following:

	2000	March 31, 2001
At cost:		
Leasehold land and buildings	\$3,475	\$4,940
Plant and machinery	17,533	21,571
Furniture, fixtures and equipment	7,697	9,722
Motor vehicles	1,227	2,355
Leasehold improvements	2,035	3,187
Total	31,967	41,775
Less: accumulated depreciation and amortization	(15,266)	(18,952)
Construction in progress	–	2,740
Net book value	\$16,701	\$25,563

6. Credit facilities and pledged assets

The Company has credit lines with various banks representing trade acceptances, loans and overdrafts. At March 31, 2000 and 2001 these facilities totalled \$15,439, and \$17,097, respectively, and none of these amounts were utilized at these dates. 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, 2000 and 2001, cash of \$1,951, and \$1,826, respectively, and leasehold land and buildings of \$1,409, and \$1,378, respectively, have been pledged as collateral for the above facilities.

The restricted cash at March 31, 2000 and 2001 also included \$178 and \$162 deposited into a bank account designated by the China customs department as a guarantee for the payment of customs duties.

7. Income Taxes

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

	Year ended March 31,		
	1999	2000	2001
Hong Kong	\$ 3,352	\$ 2,395	\$ 1,462
China and others	8,177	9,226	12,284
	<u>\$11,529</u>	<u>\$11,621</u>	<u>\$13,746</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 only on its taxable income arising in, or derived from, Hong Kong.

China

The Company's subsidiaries incorporated in China are subject to Chinese income taxes at the applicable tax rate (currently 10-15%) 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 exempt from Chinese income tax for two years starting from the first profit-making year, followed by a 50% exemption for the next three years. The 50% exemption for Jetcrown Industrial (Shenzhen) Limited ("Jetcrown Shenzhen") expired on December 31, 1995 but further extended from 1999 to 2001. The Company's other Chinese subsidiaries were either loss making or exempt from income tax in the years ended March 31, 1999, 2000 and 2001.

However, 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 become payable to the Chinese tax authorities.

The Company successfully obtained tax refunds in 1999 and 2000 relating to tax paid by Jetcrown Shenzhen in the 1998 and 1999 calendar years following the capitalization by Jetcrown Shenzhen of \$1,486 and \$1,421 of its retained earnings, respectively. Jetcrown Shenzhen's retained earnings of \$5,935 was capitalised in the year ended March 31, 2001 but the corresponding tax refund of \$428 has not yet been received and is included in current assets.

Had these tax holidays and concessions not been available, the tax charge would have been higher by \$165, \$487 and \$866 and the basic net income per share would have been lower by \$0.03, \$0.09 and \$0.16 for the years ended March 31, 1999, 2000 and 2001, respectively, and diluted net income per share for the years ended March 31, 1999, 2000 and 2001 would have been lower by \$0.03, \$0.09 and \$0.16, 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,		
	1999	2000	2001
Hong Kong	\$328	\$403	\$387
China	134	487	(72)
	<u>\$462</u>	<u>\$890</u>	<u>\$315</u>

Included in income taxes for China for the year ended March 31, 2001 was a credit of \$325 in respect of the tax refund arising from the capitalization of 1998 and 1999 retained earnings of Jetcrown Shenzhen.

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

	Year ended March 31,		
	1999	2000	2001
Statutory tax rate in Hong Kong	16.0%	16.0%	16.0%
Tax holidays and concessions	(3.5)	(1.0)	(6.3)
Income not subject to taxation	(8.3)	(8.4)	(9.3)
Increase in valuation allowances	1.3	0.7	1.1
(Over) underprovision of income tax in previous year	(1.3)	0.6	0.3
Others	(0.2)	(0.2)	0.5
Effective rate	<u>4.0%</u>	<u>7.7%</u>	<u>2.3%</u>

7. Income Taxes (Continued)

The components of deferred income tax are as follows:

	2000	March 31, 2001
Deferred tax asset:		
Net operating loss carryforwards	\$303	\$399
Less: Valuation allowances	(170)	(310)
	133	89
Deferred tax liability:		
Property, plant and equipment	(148)	(104)
Net deferred tax liability	\$ (15)	\$ (15)

The net operating loss carryforwards principally relate to Kwanta Precision Metal Products Co., Limited (“Kwanta”) and can be carried forward indefinitely and applied to reduce Kwanta’s future taxable income.

8. Related Party Transactions

The Company rents employee accommodations in China from Mr. S.K. Lee and Mr. M.C. Tam, executive officers of the Company and minority shareholders of Kwanasia. The charges for these premises approximate the amount negotiable, in management’s opinion, on an arms length basis. Rentals charged by them to the Company are \$15, \$12 and \$12, for the years ended March 31, 1999, 2000 and 2001, respectively.

During the year ended March 31, 2001, the Company acquired a motor car from Unicrown Limited for \$206, which approximated its fair value in which Mr. Richard Lau, a director of the Company, has a beneficial interest in that company.

9. Commitments and Contingencies

The Company leases premises under various operating leases which do not contain any renewal. Rental expense under operating leases included in the statement of income was \$1,647, \$1,833 and \$2,262 for the years ended March 31, 1999, 2000 and 2001, respectively.

At March 31, 2001, the Company was obligated under operating leases requiring minimum rentals as follows:

Years ending March 31

2002	\$2,308
2003	1,789
2004	1,045
2005	914
2006	921
2007 and after	2,344
Total minimum lease payments	<u>\$9,321</u>

At March 31, 2001, the Company had capital commitments for plant and machinery totalling \$375 which are expected to be disbursed during the year ending March 31, 2002.

10. 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 \$75, \$83 and \$142 for the years ended March 31, 1999, 2000 and 2001, 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 was 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 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 employees) as calculated under the MPF legislation. The expense related to the plan in the years ended March 31, 1999 and 2000 and that related to the plan and MPF in the year ended March 31, 2001 amounted to \$24, \$26 and \$30, respectively.

11. Stock Option Plan

On March 15, 1995, the Company adopted a stock option plan that permits the Company to grant options to officers, directors, employees and others to purchase up to 450,000 shares of Common Stock. On September 29, 1998, the Company approved an increase of 244,000 shares making a total of 694,000 shares of common stock available under the stock option plan. Options granted under the stock option plan will be exercisable for a period of up to 10 years, 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 parenthetical weighted average prices per share) is as follows:

	Number of stock options		
	1999	2000	2001
Outstanding at beginning of the year (\$12.59 for 1999, 2000 and 2001)	440,000	440,000	440,000
Granted during the year (\$15.80 for 2001)	–	–	10,000
Exercised during the year (\$10.98 for 2001)	–	–	(250,000)
Outstanding and exercisable at end of the year (\$12.59 for 1999 and 2000 and \$14.75 for 2001)	440,000	440,000	200,000
Range of exercise price per share	\$10 to \$14.75	\$10 to \$14.75	\$14.75

The weighted average remaining contractual life of the share options outstanding at March 31, 2001 was 6.81 years. At March 31, 2000 and March 31, 2001, there were 44,000 and 34,000 options available for future grant under the plan.

Since the Company continues to account for its stock-based awards to employees using the intrinsic value method in accordance with APB No. 25, SFAS No.123, "Accounting for Stock-Based Compensation" requires the disclosure of pro forma net income and net income per share had the Company adopted the fair value method as follows:

	1999	2000	2001
Net income:			
As reported	\$9,492	\$10,298	\$12,810
Pro forma	9,492	10,298	12,766
Basic net income per share:			
As reported	\$1.73	\$1.90	\$2.38
Pro forma	1.73	1.90	2.37
Diluted net income per share:			
As reported	\$1.72	\$1.89	\$2.36
Pro forma	1.72	1.89	2.35

The fair value of options granted in the year ended March 31, 2001 was estimated as approximately \$2.92 per share using the Black-Scholes option pricing model with the following assumptions:

Risk-free interest rate - weighted average	4.99%
Expected life of options - weighted average	3 years
Expected volatility	53%
Expected dividend yield	6.17%

12. 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, 1999, 2000 and 2001 are as follows:

	Percentage of net sales		
	Year ended March 31,		
	1999	2000	2001
Inter-Tel Incorporated	23.5%	25.3%	20.0%
Kyocera Mita Industrial Co. (H.K.) Limited	24.9%	24.0%	18.7%
Vtech Communications Limited	12.4%	22.1%	17.6%
Epson Precision (H.K.) Limited	*	*	13.0%
Behringer Holdings (Pte) Ltd.	16.0%	*	*
Namtai Electronics (Shenzhen) Company Limited	11.2%	*	*
* Less than 10%			

Sales to Inter-Tel Incorporated, Kyocera Mita Industrial Co. (H.K.) Limited, Vtech Communications Limited and Epson Precision (H.K.) Limited 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, 2000 and 2001, respectively, are as follows:

	Percentage of accounts receivable	
	2000	March 31, 2001
Largest receivable balances	69.9%	80.5%

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, 1999, 2000 and 2001.

13. Fair Value of Financial Instruments

The following disclosure of the estimated fair value of financial instruments is made in accordance with the requirements of SFAS Statement No. 107, "Disclosures About Fair Value of Financial Instruments". The estimated fair value amounts have been determined by the Company, using available market information and appropriate valuation methodologies. The estimates presented herein are not necessarily indicative of the amounts that the Company could realize in a current market exchange.

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

14. 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, 1999, 2000 and 2001 are as follows:

14. Segment Information (Continued)

	1999			2000			Year ended March 31, 2001		
	Intersegment			Intersegment			Intersegment		
	Net sales	sales	Profit	Net sales	sales	Profit	Net sales	sales	Profit
Segment:									
Injection molded plastic parts	\$30,080	\$ 203	\$8,232	\$39,272	\$ -	\$10,571	\$50,531	\$ 270	\$12,360
Electronic products	21,861	118	3,534	21,140	123	2,145	28,647	25	3,003
Metallic parts	3,362	1,543	(213)	3,968	3,299	(1,063)	5,906	3,942	(1,581)
Segment total	\$55,303	\$1,864	\$11,553	\$64,380	\$3,422	\$11,653	\$85,084	\$4,237	\$13,782
Reconciliation to consolidated totals:									
Sales eliminations	(1,864)	(1,864)	-	(3,422)	(3,422)	-	(4,237)	(4,237)	-
Goodwill amortization not allocated to segment	-	-	(24)	-	-	(32)	-	-	(36)
Consolidated totals:									
Net sales	\$53,439	\$ -		\$60,958	\$ -		\$80,847	\$ -	
Income before income taxes and minority interests			\$11,529			\$11,621			\$13,746
	1999			2000			Year ended March 31, 2001		
	Identifiable assets	Capital expenditure	Depreciation and amortization	Identifiable assets	Capital expenditure	Depreciation and amortization	Identifiable assets	Capital expenditure	Depreciation and amortization
Segment:									
Injection molded plastic parts	\$44,513	\$1,468	\$2,207	\$50,112	\$5,119	\$2,535	\$60,704	\$11,817	\$2,625
Electronic products	19,871	2,663	1,328	23,431	600	1,361	26,821	1,589	1,437
Metallic parts	3,462	151	664	5,037	300	856	6,149	520	941
Segment totals	\$67,846	\$4,282	\$4,199	\$78,580	\$6,019	\$4,752	\$93,674	\$13,926	\$5,003
Reconciliation to consolidated totals:									
Elimination of receivables from intersegments	(3,930)	-	-	(7,288)	-	-	(10,721)	-	-
Goodwill not allocated to segments	357	-	24	549	-	32	513	-	36
Consolidated totals	\$64,273	\$4,282	\$4,223	\$71,841	\$6,019	\$4,784	\$83,466	\$13,926	\$5,039

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

	Year ended March 31,		
	1999	2000	2001
Net sales			
Hong Kong	\$13,857	\$14,704	\$15,557
Export sales			
China	17,292	25,958	44,078
U.S.A.	13,072	16,488	18,282
Europe	8,531	3,056	1,763
Other	687	752	1,167
Total net sales	\$53,439	\$60,958	\$80,847

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

	1999	2000	March 31, 2001
Hong Kong	\$47,116	\$46,982	\$47,520
China	16,800	24,310	35,433
Goodwill	357	549	513
Total identifiable assets	\$64,273	\$71,841	\$83,466

CORPORATE INFORMATION

Board of Directors and Senior Management

The Board of Directors and executive officers of the Company at June 30, 2001 are as follows:

<i>Name</i>	<i>Position(s) with Company</i>
Board of Directors	
Richard Pui-Hon LAU	Chairman and Chief Executive Officer
Chin-Pang LI	Executive Director, General Manager (Plastic Operations), Chief Financial Officer and Company Secretary
Chi-Wai LEUNG	Executive Director, Director of Engineering (Plastic Operations)
Stephen K. SEUNG	Non-executive Director and member of Audit Committee
Hung-Hum LEUNG	Non-executive Director and member of Audit Committee

Senior Management

Shu-Kwan LEE	Director of Administration and Marketing (Electronic & Metallic Operations)
Man-Chi TAM	Director of Engineering and Manufacturing (Electronic & Metallic Operations)
Dickson LAM	Director of Marketing (Electronics Operations)
Michael YEM	Director of Marketing (Plastic Operations)
Eliza Y. P. PANG	Financial Controller
William SONG	Marketing Manager (Plastic Operations)
Franki TSE	Marketing Manager (Plastic Operations)
Ken LEE	Marketing Manager (Plastic Operations)

Employees

At March 31, 2001, the Company employed 4,089 persons on a full-time basis, with 43 based in Hong Kong and 4,046 in China. These employees were distributed amongst the Company's operations as follows: 2,512 engaged in plastic injection molding manufacturing, 1,216 in contract electronic manufacturing, and 361 in metal molds and parts manufacturing. The company has experienced no significant labor disputes or stoppages.

Registered Office

Deswell Industries, Inc.
H.W.R. Services Limited
P. O. Box 71, Craigmuir Chambers, Road Town, Tortola, British Virgin Islands

Corporate Website

<http://www.deswell.com>

Corporate Office

Jetcrown Industrial Limited
Unit 514-517, Hong Leong Industrial Complex, 4 Wang Kwong Road, Kowloon Bay, Hong Kong
Tel: (852) 2796-6993
Fax: (852) 2796-7741
<http://www.jetcrown.com>

Hong Kong Subsidiaries Office

Kwanasia Electronics Company Limited
Kwanta Precision Metal Products Company Limited
Unit 10-14, 19/F., Kwong Sang Hong Centre, 151-153 Hoi Bun Road, Kwun Tong, Hong Kong
Tel: (852) 2342-2286
Fax: (852) 2797-8159
<http://www.kwanasia.com>

PRC Factories

Jetcrown Industrial (Shenzhen) Limited
Block A-H, Wing Village Industrial Estate, Shekou, Shenzhen, China
Tel: (86) 755-669-7120
Fax: (86) 755-669-7119

Jetcrown Industrial (Dongguan) Limited
Huangguan Industrial Estate, Houjie Town, Dongguan, China
Tel: (86) 769-582-0406
Fax: (86) 769-582-0407

Kwan Hong Electronics Company Limited
Xiaobian 2nd Industrial Zone, Chang An, Dongguan, China
Tel: (86) 769-553-7201
Fax: (86) 769-553-9301

Kwanta Precision Metal Products Company Limited
Xiaobian 2nd Industrial Zone, Chang An, Dongguan, China
Tel: (86) 769-531-2362
Fax: (86) 769-531-5690

Annual Meeting

The Annual General Meeting of Shareholders will be held at 10:00 a.m. on September 24, 2001 in the Linden Room of the Four Seasons Hotel, 300 S. Doheny Drive, Los Angeles, CA 90048, U.S.A.

Stock Listing

The common shares of Deswell Industries, Inc., are traded on the Nasdaq National Market System under the stock symbol "DSWL".

Transfer Agent and Registrar

Communications regarding change of address, transfer of common shares, or lost certificates should be directed to:

U.S. Stock Transfer Corp.
1745 Gardena Avenue, Glendale, California 91204-2991, U.S.A.

Shareholders' Information

For further information about the Company, investors and analysts should contact the Company's Investors Relation Consultant:

Lippert/Heilshorn & Associates, Inc.
800 Third Avenue, Suite 1701, New York, NY 10022
Tel: (212) 838-3777
Fax: (212) 838-4568

Auditors

Deloitte Touche Tohmatsu
26/F Wing On Centre, 111 Connaught Road, Central, Hong Kong

SEC Counsel

Kirkpatrick & Lockhart LLP
10100 Santa Monica Boulevard, Los Angeles, California, U.S.A.

Bankers

The Hongkong and Shanghai Banking Corporation Limited
The Sanwa Bank Limited
The Standard Chartered Bank