SIMPLETECH INC
Form 10-Q
August 14, 2003

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

ý QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended June 30, 2003

or

o TRANSITION REPORT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from to

Commission File Number 000-31623

SIMPLETECH, INC.

(Exact name of Registrant as specified in its charter)

CALIFORNIA	**33-0399154**

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

Indicate by check mark whether the registrant is an accelerated filer (as described in Exchange Act Rule 12b-2). Yes o No ý

The number of shares outstanding of the Registrant s common stock, par value $0.001, as of June 30, 2003 was 38,914,423.

SIMPLETECH, INC.

INDEX TO FORM 10-Q FOR THE

QUARTERLY PERIOD ENDED JUNE 30, 2003

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

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

SimpleTech, Inc.

Consolidated Balance Sheets

(in thousands, except share and per share amounts)

(unaudited)

	June 30, 2003	December 31, 2002
ASSETS:		
Current Assets:		
Cash and cash equivalents	$ 34,036	$ 33,992
Marketable securities	9,980	9,980
Accounts receivable, net of allowances of $763 at June 30, 2003 and $782 at December 31, 2002	16,572	19,019
Inventory, net	15,462	14,141
Income taxes receivable	2,799	3,860
Deferred income taxes		28
Other current assets	804	59
Total current assets	79,653	81,079
Furniture, fixtures and equipment, net	9,003	10,169
Intangible assets	378	835
Deferred income taxes	4,327	2,378
Total assets	$ 93,361	$ 94,461
LIABILITIES AND SHAREHOLDERS EQUITY:		
Current Liabilities:		
Accounts payable	$ 18,414	$ 16,381
Current maturities of capital lease obligations		113
Accrued and other liabilities	3,091	4,152
Deferred income taxes	231	
Total current liabilities	21,736	20,646
Total liabilities	21,736	20,646
Commitments and contingencies (Note 5)		
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, 38,914,423 shares issued and outstanding as of June 30, 2003 and 38,725,800 shares issued and outstanding as of December 31, 2002	39	39
Additional paid-in capital	67,051	66,716
Retained earnings	4,535	7,060
Total shareholders equity	71,625	73,815
Total liabilities and shareholders equity	$ 93,361	$ 94,461

See accompanying notes to unaudited consolidated financial statements.

SimpleTech, Inc.

Consolidated Statements of Operations

(in thousands, except per share amounts)

(unaudited)

	Three Months Ended June 30, 2003	Three Months Ended June 30, 2002	Six Months Ended June 30, 2003	Six Months Ended June 30, 2002
Net revenues	$ 44,745	$ 43,301	$ 85,663	$ 94,253
Cost of revenues	37,021	37,167	71,008	76,643
Gross profit	7,724	6,134	14,655	17,610
Sales and marketing	4,958	4,230	10,330	9,067
General and administrative	2,361	2,673	4,875	5,704
Research and development	2,055	2,007	4,172	3,945
In-process research and development				1,360
Total operating expenses	9,374	8,910	19,377	20,076
Loss from operations	(1,650)	(2,776)	(4,722)	(2,466)
Interest and other, net	125	187	276	396
Loss before benefit for income taxes	(1,525)	(2,589)	(4,446)	(2,070)
Benefit for income taxes	(661)	(1,873)	(1,921)	(1,667)
Net loss	$ (864)	$ (716)	$ (2,525)	$ (403)
Net loss per share:				
Basic	$ (0.02)	$ (0.02)	$ (0.06)	$ (0.01)
Diluted	$ (0.02)	$ (0.02)	$ (0.06)	$ (0.01)
Shares used in computation of net loss per share:				
Basic	38,905	38,476	38,874	38,414
Diluted	38,905	38,476	38,874	38,414

See accompanying notes to unaudited consolidated financial statements.

SimpleTech, Inc.

Consolidated Statements of Cash Flows

(in thousands)

(unaudited)

	Six Months Ended June 30, 2003		Six Months Ended June 30, 2002	
Cash flow from operating activities:				
Net loss	$	(2,525)	$	(403)
Adjustments to reconcile net loss to net cash provided by operating activities:				
Depreciation and amortization		2,069		1,691
Gain (loss) on sale of furniture, fixtures and equipment		(22)		89
Accounts receivable provisions		747		696
Inventory excess and obsolescence expense		195		477
In-process research and development				1,360
Deferred income taxes		(1,690)		
Compensation related to stock options vesting				11
Tax benefit from exercise of stock options		68		
Change in operating assets and liabilities:				
Accounts receivable		1,700		(3,702)
Inventory		(1,516)		(98)
Income taxes receivable		1,061		686
Other assets		(450)		(363)
Accounts payable		2,033		309
Accrued and other liabilities		(1,061)		670
Net cash provided by operating activities		609		1,423
Cash flows from investing activities:				
Purchase of furniture, fixtures and equipment		(823)		(3,859)
Proceeds from sale of furniture, fixtures and equipment		104		651
Acquisition of assets				(2,295)
Net cash used in investing activities		(719)		(5,503)
Cash flows from financing activities:				
Repayment of borrowings from banks				(387)
Payment on capital lease obligations		(113)		(216)
Proceeds from issuance of common stock		267		472
Net cash provided by (used in) financing activities		154		(131)
Net increase (decrease) in cash		44		(4,211)
Cash and cash equivalents at beginning of period		33,992		51,831

Cash and cash equivalents at end of period	$	34,036	$	47,620

See accompanying notes to unaudited consolidated financial statements.

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 presentation of the consolidated financial position of the Company at June 30, 2003 and the consolidated results of operations and cash flows for the three months and six months ended June 30, 2003 and 2002 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, 2002 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, 2002. 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

Risks and Uncertainties:

Financial instruments, which potentially subject the Company to a concentration of credit risk, principally consist of cash and cash equivalents and accounts receivable. As of June 30, 2003 and December 31, 2002, approximately 14% and 15%, respectively, of accounts receivable were concentrated with one customer, Ingram Micro. For the three months ended June 30, 2003, CDW Computer Centers and Sam s Club comprised 19% and 12%, respectively, of the Company s revenues. For the three months ended June 30, 2002, CDW Computer Centers and Unisys comprised 21% and 14%, respectively, of the Company s revenues. For the six months ended June 30, 2003 and 2002, sales to CDW Computer Centers comprised 21% and 21%, respectively, of the Company s revenues. No other single customer accounted for more than 10% of accounts receivable at June 30, 2003 and December 31, 2002, or revenues for the three months and six months ended June 30, 2003 and 2002.

Warranties:

The Company's memory products are generally sold under various limited warranty arrangements. The estimated future costs of repair or replacement are immaterial and have approximated management's estimates.

Management 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.

Recently Issued Accounting Standards:

In January 2003, the FASB issued Interpretation No. 46, Consolidation of Variable Interest Entities an interpretation of ARB No. 51. The objective of FIN 46 is to improve financial reporting by companies involved with variable interest entities. This new model for consolidation applies to an entity in which either (1) the powers or rights of the equity holders do not give them sufficient decision making powers or (2) the equity investment at risk is insufficient to finance that entity's activities without receiving additional subordinated financial support from other parties. FIN 46 requires a variable interest entity to be consolidated into the company that is subject to a majority of the risk of loss from the variable interest entity's activities or that is entitled to receive a majority of the entity's residual returns or both. The consolidation requirements of FIN 46 apply immediately to variable interest entities created after January 31, 2003. For entities created on or prior to January 31, 2003, the consolidation requirements apply in the first fiscal year or interim period beginning after June 15, 2003. For variable interest entities created prior to January 31, 2003, the Company is currently evaluating the impact of the adoption of FIN 46 for these entities, and thus is not able to disclose the impact on the Company's results of operations, financial position or cash flows.

Note 3 Net Income (Loss) Per Share

Basic earnings per share is computed by dividing net 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 9.3 million and 7.2 million shares of common stock were outstanding at June 30, 2003 and 2002, respectively. For the three months and six months ended June 30, 2003 and 2002, no potential common shares were included in the diluted per share amount as the effect would have been anti-dilutive.

Pursuant to SFAS No. 123, Accounting for Stock-Based Compensation, the Company has elected to continue the intrinsic value method of accounting for stock options granted to employees and directors in accordance with APB Opinion No. 25 and related interpretations in accounting for stock option plans. Had compensation cost been determined based on the fair value at the grant dates for stock options under the Plan consistent with the method promulgated by SFAS No. 123, the Company s net loss for the three months and six months ended June 30, 2003 and 2002, would have resulted in the pro forma amounts below:

	Three Months Ended June 30, 2003	Three Months Ended June 30, 2002	Six Months Ended June 30, 2003	Six Months Ended June 30, 2002
Net loss, as reported	$ (864)	$ (716)	$ (2,525)	$ (403)
Add: Stock-based compensation expense included in reported net loss, net of related tax effects		1		7
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(956)	(561)	(1,723)	(1,127)
Pro forma net loss	$ (1,820)	$ (1,276)	$ (4,248)	$ (1,523)
Loss per share:				
Basic - as reported	$ (0.02)	$ (0.02)	$ (0.06)	$ (0.01)
Basic - pro forma	$ (0.05)	$ (0.03)	$ (0.11)	$ (0.04)
Diluted - as reported	$ (0.02)	$ (0.02)	$ (0.06)	$ (0.01)
Diluted - pro forma	$ (0.05)	$ (0.03)	$ (0.11)	$ (0.04)

Note 4 Supplemental Balance Sheet Information

Inventory consists of the following:

(in thousands)	**June 30, 2003**	**December 31, 2002**
Raw materials	$ 6,663	$ 6,325
Work-in-progress	634	364
Finished goods	9,073	8,256
	16,370	14,945
Valuation allowances	(908)	(804)
Inventory, net	$ 15,462	$ 14,141

Note 5 Commitments and Contingencies

DPAC Technologies, Inc. Patent Infringement

On September 23, 1998, the Company filed a lawsuit against DPAC Technologies, Inc., formerly Dense-Pac Microsystems, Inc. (DPAC), in the United States District Court for the Central District of California for infringement of the Company s IC Tower stacking patent, U.S. Patent No. 5,514,907. On March 29, 2001, the court entered final judgment finding DPAC did not infringe the Company s patent and that the Company did not infringe DPAC s patent. The appeals court affirmed the final judgment on March 7, 2002. DPAC did not appeal the ruling in the Company s favor, and that ruling is now final. On September 3, 2002, the Company filed a petition for certiorari with the U.S. Supreme Court. On October 7, 2002, the petition to the Supreme Court was granted and the matter was remanded to the Circuit Court of Appeals. DPAC filed a motion for summary affirmance with the Court of Appeals. On February 26, 2003, the Court of Appeals denied DPAC s motion and remanded the matter for trial to the United States District Court for the Central District of California. No trial date has been set by the District Court.

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. Because of the preliminary stage of this case, an estimate of potential damages, if any, would be premature and speculative, and the Company has not made any such estimate at this time.

Lexar Media, Inc. Unfair Trade Practice and Patent Infringement

On October 1, 2002, the Company filed a lawsuit against Lexar Media, Inc. in the Superior Court of Orange County, California for trade libel, libel per se, intentional interference with prospective economic advantage and California unfair competition, seeking unspecified damages, including punitive and trebled damages. The lawsuit arose from correspondence sent by Lexar Media to one of the Company s customers that alleged that certain of the Company s products infringe Lexar Media s patents. On October 30, 2002, Lexar Media filed a notice of removal, which removed the matter from the Orange County Superior Court to the United States District Court for the Central District of California. On November 14, 2002, the Company amended its complaint to add violation of the Sherman Antitrust Act, violation of the California Unfair Trade Practices Act and common law unfair competition as causes of action. On November 6, 2002, Lexar Media filed a motion to dismiss the Company s complaint. On January 8, 2003, the Court denied Lexar s motion as to the initial four causes of actions and dismissed the violation of the Sherman Antitrust Act, violation of the California Unfair Trade Practices Act and common law unfair competition causes of actions against Lexar Media.

On July 21, 2003, Lexar filed a motion for summary judgment seeking dismissal of the Company's amended complaint and a Rule 11 motion requesting sanctions against the Company for filing the amended complaint. On August 11, 2003, the Court ruled on Lexar's motion for summary judgment on SimpleTech's underlying causes of action. According to the Court's ruling, there was not clear and convincing evidence that Lexar's actions were conducted in bad faith. As a result, the Court granted Lexar's motion for summary judgment, but denied Lexar's Rule 11 motion.

On March 20, 2003, Lexar Media filed a counter claim against the Company alleging that the Memory Stick products sold by the Company violate Lexar Media s U.S. patent No. 5,479,638. Lexar Media is seeking monetary damages in an amount to be stated later, an injunction against further infringement of its patent, attorneys fees and trebled damages. The Company purchases its Memory Stick products from I-O Data. Under the terms of the distribution agreement with I-O Data, I-O Data has agreed to indemnify, defend and hold harmless the Company from claims, damages, losses and costs which may arise from the alleged infringement by its products of third-party patents, trademarks or other proprietary rights. After initially agreeing to indemnify and assume the Company s defense, I-O Data has failed to assume the Company s defense. As a result, SimpleTech has filed an answer to Lexar Media s counter claim and filed a Third-Party Complaint against I-O Data asking for indemnification. This lawsuit is in the early stage of discovery and the court has set a trial for April 2004. Because of the preliminary stage of this case, an estimate of potential damages, if any, would be premature and speculative, and the Company has not made any such estimate at this time.

Staktek Corporation Patent Infringement

On July 30, 2003, the Company filed a lawsuit against Staktek Corporation in the United States District Court for the Central District of California for infringement of the Company s IC Tower stacking patent, U.S. Patent No. Re. 36,916. The Company is seeking monetary damages in an amount to be stated later, an injunction against further infringement of the Company's patent, attorneys' fees and trebled damages. No court dates have been set.

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, including, but not limited to, employee, customer and vendor disputes and intellectual property litigation.

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.

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, 2003, the Company has not been required to repurchase inventory in connection with the customer default agreements noted above. However, it may be possible that the Company will be required to repurchase inventory, upon customer default, in the future. Sales under such agreements were approximately $276,000 and $510,000 in the second quarter and first half of 2003, respectively, compared to $177,000 and $366,000 in the second quarter and first half of 2002, respectively.

Note 6 Segment Information

Historically, the Company has reported financial results for two reportable operating segments, Commercial and Industrial. In January 2002, the Company acquired the assets of Irvine Networks, which was subsequently renamed the Xiran Division, and reports the Division s operating results as a third operating segment.

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 and reflect the information used by the Company s management to evaluate the performance of its segments. For the Commercial and Industrial segments, the Company tracks separately net sales and gross profit, but does not track separately operating expenses, interest or income taxes. For the Xiran segment, which is not expected to produce revenues until 2004, the Company currently tracks operating expenses only. The Company does not maintain separate records to identify assets by operating segment.

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

Three Months Ended June 30, 2003	Six Months Ended June 30, 2003

(in thousands)	Commercial	Industrial	Subtotal	Xiran	Consolidated	Commercial	Industrial	Subtotal	Xiran	Consolidated

Net revenues	$ 36,072	$ 8,673	$ 44,745	$ 0	$ 44,745	$ 67,843	$ 17,820	$ 85,663	$ 0	$ 85,663
Cost of revenues	30,164	6,857	37,021	0	37,021	57,589	13,419	71,008	0	71,008
Gross profit	$ 5,908	$ 1,816	7,724	0	$ 7,724	$ 10,254	$ 4,401	14,655	0	$ 14,655
Operating expenses			7,390	1,984	9,374			15,519	3,858	19,377
Income (loss) from operations			$ 334	$ (1,984)	$ (1,650)			$ (864)	$ (3,858)	$ (4,722)

	Three Months Ended June 30, 2002					**Six Months Ended June 30, 2002**				
	Commercial	**Industrial**	**Subtotal**	**Xiran**	**Consolidated**	**Commercial**	**Industrial**	**Subtotal**	**Xiran**	**Consolidated**
Net revenues	$ 29,791	$ 13,510	$ 43,301	$ 0	$ 43,301	$ 73,416	$ 20,837	$ 94,253	$ 0	$