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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**  
Washington, D.C. 20549

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**FORM 10-Q**

(Mark One)

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended September 30, 2003

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number: 0-28472

**DIGITAL VIDEO SYSTEMS, INC.**

(Exact name of registrant as specified in its charter)

**Delaware**

(State or other jurisdiction of  
incorporation or organization)

**77-0333728**

(I.R.S. Employer  
Identification Number)

**430 Cambridge Avenue, Suite 110**

**Palo Alto, CA 94306**

(Address of principal executive offices, including zip code)

**(650) 322-8108**

(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 reports), and (2) has been subject to such filing requirements for the past 90 days.  
Yes  No

Indicate by check mark whether the registrant is an accelerated filed (as defined in Rule 12b-2 of the Exchange Act).  
Yes  No

As of September 30, 2003, there were approximately 8,175,898 shares of the registrant's common stock outstanding.

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**DIGITAL VIDEO SYSTEMS, INC.**  
**FORM 10-Q**

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## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements

## Digital Video Systems, Inc.

Condensed Consolidated Balance Sheet  
(In Thousands)

	September 30, 2003	December 31, 2002
	(Unaudited)	
<b>ASSETS:</b>		
<b>Current assets:</b>		
Cash and cash equivalents.....	\$ 8,258	\$ 12,330
Restricted cash .....	6,219	5,908
Accounts receivable, net .....	8,118	10,749
Inventories .....	26,480	25,758
Marketable debt securities.....	438	427
Prepaid expenses and other current assets.....	4,003	3,402
Notes receivable – related party .....	1,084	884
<b>Total current assets .....</b>	<b>54,600</b>	<b>59,458</b>
Property and equipment, net .....	12,282	11,067
Intangibles .....	398	587
Other assets.....	601	315
<b>Total assets .....</b>	<b>\$ 67,881</b>	<b>\$ 71,427</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY:</b>		
<b>Current Liabilities:</b>		
Line of credit.....	\$ 27,722	\$ 26,086
Current portion of long term debt .....	—	192
Notes payable.....	5,085	4,223
Accounts payable .....	11,335	13,592
Accounts payable – related party .....	515	434
Accrued liabilities .....	2,322	3,325
Other payable.....	87	234
<b>Total current liabilities .....</b>	<b>47,066</b>	<b>48,086</b>
<b>Long term liabilities:</b>		
Long term liabilities – long term debt .....	—	96
<b>Total liabilities .....</b>	<b>47,066</b>	<b>48,182</b>
<b>Minority interest .....</b>	<b>12,009</b>	<b>13,434</b>
<b>Stockholders' equity:</b>		
Preferred stock .....	—	—
Common stock .....	1	1
Additional paid-in capital.....	76,402	73,334
Accumulated other comprehensive loss.....	1,864	1,457
Deferred compensation .....	(6)	(20)
Accumulated deficit.....	(69,455)	(64,961)
<b>Total stockholders' equity .....</b>	<b>8,806</b>	<b>9,811</b>
<b>Total liabilities and stockholders' equity .....</b>	<b>\$ 67,881</b>	<b>\$ 71,427</b>

See accompanying notes to condensed consolidated financial statements.

**Digital Video Systems, Inc.**

**Condensed Consolidated Statements of Operations**  
**(In Thousands, except Per Share Amounts)**  
**(Unaudited)**

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2003	2002	2003	2002
<b>Net revenue</b>	<b>\$ 19,677</b>	<b>\$ 47,756</b>	<b>\$ 70,603</b>	<b>\$ 113,182</b>
Cost of revenue.....	17,469	43,184	64,833	102,758
Gross margin.....	<u>2,208</u>	<u>4,572</u>	<u>5,770</u>	<u>10,424</u>
<b>Operating expenses:</b>				
Research and development.....	1,364	953	4,033	2,640
Sales and marketing.....	634	879	2,196	2,001
General and administrative.....	<u>1,519</u>	<u>1,266</u>	<u>5,008</u>	<u>4,673</u>
<b>Total operating expenses.....</b>	<b><u>3,517</u></b>	<b><u>3,098</u></b>	<b><u>11,237</u></b>	<b><u>9,314</u></b>
<b>(Loss) income from operations.....</b>	<b><u>(1,309)</u></b>	<b><u>1,474</u></b>	<b><u>(5,467)</u></b>	<b><u>1,110</u></b>
Interest (expense) income, net.....	(378)	(625)	(921)	(1,389)
Other (expense) income.....	<u>(732)</u>	<u>1,503</u>	<u>(145)</u>	<u>(23)</u>
(Loss) income before minority interest and income taxes.....	(2,419)	2,352	(6,533)	(302)
Income tax benefit (provision).....	230	(280)	228	(332)
Minority interest.....	<u>593</u>	<u>(225)</u>	<u>1,811</u>	<u>(317)</u>
<b>Net (loss) income.....</b>	<b><u>\$ (1,596)</u></b>	<b><u>\$ 1,847</u></b>	<b><u>\$ (4,494)</u></b>	<b><u>\$ (951)</u></b>
Net (loss) income per share – basic and diluted.....	<u>\$ (0.20)</u>	<u>\$ 0.31</u>	<u>\$ (0.63)</u>	<u>\$ (0.16)</u>
Weighted average common shares and equivalent outstanding.....	<u>7,949</u>	<u>5,889</u>	<u>7,090</u>	<u>5,889</u>

**See accompanying notes to condensed consolidated financial statements.**

**Digital Video Systems, Inc.**

**Condensed Consolidated Statements of Cash Flows  
(In Thousands)  
(Unaudited)**

	<u>Nine Months Ended September 30,</u>	
	<u>2003</u>	<u>2002</u>
<b>Cash flows from operating activities:</b>		
Net loss .....	\$ (4,494)	\$ (951)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Minority interest .....	(1,811)	317
Depreciation and amortization .....	2,091	1,999
Issuance of common stock for service provided .....	166	200
Write (up) down of notes receivable .....	(200)	730
Allowance for doubtful accounts .....	(200)	—
Amortization of deferred compensation .....	14	30
Extinguishment of accounts payable in connection with legal settlement .....	334	—
Deferred tax assets .....	(284)	—
Noncash interest expense .....	132	—
<b>Changes in operating assets and liabilities:</b>		
Accounts receivable .....	2,831	(10,479)
Inventories .....	(722)	(41,538)
Prepaid expenses and other current assets .....	(313)	(621)
Other assets .....	(2)	(28)
Accounts payable .....	(2,379)	30,648
Accrued liabilities .....	(197)	(957)
Other payables and related party payable .....	(66)	427
<b>Net cash used in operating activities .....</b>	<b><u>(5,100)</u></b>	<b><u>(20,223)</u></b>
<b>Cash flows from investing activities:</b>		
Acquisition of property and equipment .....	(3,117)	(2,465)
Maturities (purchase) of marketable debt securities .....	(11)	(54)
Increase in restricted cash .....	(311)	(2,658)
<b>Net cash used in investing activities .....</b>	<b><u>(3,439)</u></b>	<b><u>(5,177)</u></b>
<b>Cash flows from financing activities:</b>		
Proceeds from the exercise of options and warrants .....	113	45
Proceeds from sale of subsidiary stock .....	55	10,673
Proceeds from sale of stock, net .....	1,035	—
Proceeds from bridge loans .....	261	—
Net proceeds from line of credit .....	1,636	(64)
Proceeds from (repayment of) notes payable .....	862	(18)
Proceeds from line of credit borrowings .....	—	19,062
Repayment of long term debt .....	(288)	—
<b>Net cash provided by financing activities .....</b>	<b><u>3,674</u></b>	<b><u>29,698</u></b>
Effect of exchange rate changes .....	793	709
Net (decrease) increase in cash and cash equivalents .....	<u>(4,072)</u>	<u>5,007</u>
Cash and cash equivalents at beginning of period .....	12,330	10,145
<b>Cash and cash equivalents at end of period .....</b>	<b><u>\$ 8,258</u></b>	<b><u>\$ 15,152</u></b>
<b>Supplemental disclosures:</b>		
Interest paid .....	\$ 933	\$ 1,036
Taxes paid .....	60	466
<b>Supplemental disclosures of non-cash transaction:</b>		
Issuance of common stock in payment of accounts payable .....	\$ 210	\$ —
Issuance of common stock in payment of accrued liabilities .....	813	—
Issuance of common stock in other receivables .....	247	—

See accompanying notes to condensed consolidated financial statements.

## **Digital Video Systems, Inc.**

### **Notes to Condensed Consolidated Financial Statements (Unaudited)**

#### **1. Basis of Presentation**

The accompanying unaudited condensed consolidated financial statements of Digital Video Systems, Inc. (the Company or DVS) include the accounts of the Company and its subsidiaries. The statements have been prepared by the Company in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements and should be read in conjunction with the audited financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2002.

In the opinion of the management, the accompanying unaudited condensed consolidated financial statements have been prepared on the same basis as the audited financial statements and include all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation of the interim periods presented. Operating results for the three-month and nine-month periods ended September 30, 2003 are not necessarily indicative of the results that may be expected for any other interim period or the full fiscal year ending December 31, 2003. All significant inter-company balances and transactions have been eliminated.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Significant estimates include impairment write-downs of fixed assets and intangibles and the level of accounts receivable and inventory reserves. Actual results could differ from those estimates.

#### **2. Recent Accounting Pronouncements**

In December 2002, the FASB issued SFAS No. 148, "Accounting for Stock-Based Compensation-Transition and Disclosure." This Statement amends SFAS No. 123, "Stock-Based Compensation," to provide alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, this Statement amends the disclosure requirements of SFAS No. 123 to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. The alternative methods of transition of SFAS No. 148 are effective for fiscal years ended after December 15, 2002. The Company follows APB 25 in accounting for employee stock options. The disclosure provisions of SFAS No. 148 are effective for fiscal years ending after December 15, 2002 and have been incorporated into these financial statements and accompanying footnotes. See Note 3 to Notes to Condensed Consolidated Financial Statements.

In November 2002, the FASB issued Interpretation No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others," which requires a guarantor to recognize and measure certain types of guarantees at fair value. In addition, Interpretation No. 45 requires the guarantor to make new disclosures for these guarantees and other types of guarantees that are not subject to the initial recognition and initial measurement provisions. The disclosure requirements are effective for financial statements for interim or annual periods ended after December 15, 2002, while the recognition and measurement provisions are applicable on a prospective basis to guarantees issued or modified after December 31, 2002. The Company is in the process of evaluating the impact the initial recognition and initial measurement provisions will have on its consolidated financial position and results of operations.

In May 2003, the FASB issued Statement of Financial Accounting Standards No. 150 ("SFAS 150"), "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity". SFAS 150 establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in certain circumstances). Many of these instruments were previously classified as equity. Although some of the

provisions of this statement are consistent with the current definition of liabilities in FASB Concepts Statement No. 6, "Elements of Financial Statements", the remainder are consistent with FASB's intention to revise that definition to encompass certain obligations that a reporting entity can or must settle by issuing its own shares. This statement is effective for financial instruments entered into or modified after May 31, 2003 and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. There was no impact to the condensed consolidated financial statements related to SFAS 150 for the nine months ended September 30, 2003.

### 3. Accounting for Stock-Based Compensation

The Company accounts for stock based employee compensation using the intrinsic value method under Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB 25"), and related interpretations and complies with the disclosure provisions of Statement of Financial Accounting Standards No. 148, "Accounting for Stock-Based Compensation, Transition and Disclosure – an Amendment of FASB Statement No. 123".

The following table illustrates the effect on net income (loss) and net income (loss) per share if the Company had applied the fair value recognition provisions of Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" to stock based compensation.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2003	2002	2003	2002
Reported net (loss) income .....	\$ (1,596)	\$ 1,847	\$ (4,494)	\$ (951)
Add: Stock-based compensation, as reported.....	5	10	14	30
Deduct: Total stock-based compensation determined under fair value based method for all awards.....	(168)	(147)	(442)	(441)
Adjusted net (loss) income, fair value method for all stock- based awards.....	\$ (1,759)	\$ 1,710	\$ (4,922)	\$ (1,362)
Basic and diluted (loss) income per share – as reported.....	\$ (0.20)	\$ 0.31	\$ (0.63)	\$ (0.16)
Basic and diluted (loss) income per share – proforma.....	\$ (0.22)	\$ 0.29	\$ (0.69)	\$ (0.23)

The fair value for each option granted was estimated at the date of grant using a Black-Scholes option-pricing model, assuming no expected dividends and the following weighted average assumptions:

	Three Months Ended September 30		Nine Months Ended September 30	
	2003	2002	2003	2002
Average risk-free interest rates .....	1.61%	5.20%	1.58%	5.20%
Average expected life (in years).....	2.0	2.0	2.0	2.0
Volatility.....	155%	125%	109% - 155%	125%

The weighted average fair value of stock awards (including restricted stock units granted in 2002) granted during the three months ended September 30, 2003 and 2002 was \$1.28 and \$0.97 per share, respectively. The weighted average fair value of stock awards (including restricted stock units granted in 2002) granted during the nine months ended September 30, 2003 and 2002 was \$1.07 and \$1.18 per share, respectively.

### 4. Net Loss Per Share

Basic net loss per share is computed using the weighted average number of common shares outstanding during the periods. Diluted net loss per share is computed using the weighted average number of common and potentially dilutive common shares outstanding during the periods, except those that are anti-dilutive. Basic and diluted net loss per share is calculated as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2003	2002	2003	2002

Net loss .....	\$ (1,596)	\$ 1,847	\$ (4,494)	\$ (951)
Weighted average common shares outstanding (1).....	<u>7,949</u>	<u>5,889</u>	<u>7,090</u>	<u>5,889</u>
Basic and diluted net loss per share .....	\$ (0.20)	\$ 0.31	\$ (0.63)	\$ (0.16)

(1) At September 30, 2003, 4,824,207 shares underlying options and other warrants were excluded from the calculation of the diluted earnings per share because the effect is anti-dilutive.

## 5. Comprehensive Income (Loss)

The components of comprehensive income, net of tax, are as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2003	2002	2003	2002
Net (loss) income .....	\$ (1,596)	\$ 1,847	\$ (4,494)	\$ (951)
Cumulative foreign currency translation adjustments.....	<u>359</u>	<u>(34)</u>	<u>407</u>	<u>709</u>
Comprehensive (loss) income .....	<u>\$ (1,237)</u>	<u>\$ 1,813</u>	<u>\$ (4,087)</u>	<u>\$ (242)</u>

Accumulated other comprehensive income presented on the accompanying consolidated condensed balance sheet consists of the cumulative foreign currency translation adjustments.

## 6. Inventories

Inventories consisted of the following (in thousands)

	September 30, 2003	December 31, 2002
Inventories:		
Raw materials .....	\$ 15,311	\$ 9,718
Work-in-process.....	4,422	8,220
Finished goods .....	<u>7,714</u>	<u>8,230</u>
Total inventory .....	27,447	26,168
Less inventory reserves .....	<u>(967)</u>	<u>(410)</u>
Net inventory.....	<u>\$ 26,480</u>	<u>\$ 25,758</u>

## 7. Segment Information

The Company is organized in a single business segment, its core business of developing, producing and marketing digital video technology related products which include DVD loaders and other DVD products. While its revenue mainly comes from DVD products, the Company also generates revenue, to a lesser extent, from computer peripherals, equipment and materials.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2003	2002	2003	2002
Product line:				
DVD products.....	\$ 19,641	\$ 47,410	\$ 70,247	\$ 111,332
Computer peripherals.....	36	343	356	1,410
Equipment & materials .....	<u>—</u>	<u>3</u>	<u>—</u>	<u>440</u>
Total sales .....	<u>\$ 19,677</u>	<u>\$ 47,756</u>	<u>\$ 70,603</u>	<u>\$ 113,182</u>

A significant portion of the Company's revenue and net income is derived from international sales, particularly from customers based in Asia. Fluctuation of the U.S. dollar against foreign currencies and changes in local regulatory or economic conditions could adversely affect operating results.

Geographic information for revenues for the three and nine months ended September 30, 2003 and 2002 are as follows (in thousands):

	<u>Three Months Ended September 30,</u>		<u>Nine Months Ended September 30,</u>	
	<u>2003</u>	<u>2002</u>	<u>2003</u>	<u>2002</u>
Geographic:				
Domestic.....	\$ 30	\$ 3,027	\$ 350	\$ 4,346
Other international countries.....	<u>19,647</u>	<u>44,729</u>	<u>70,253</u>	<u>108,836</u>
Total sales .....	<u>\$ 19,677</u>	<u>\$ 47,756</u>	<u>\$ 70,603</u>	<u>\$ 113,182</u>

During the three months ended September 30, 2003, the Company had four customers which individually accounted for over 10% of sales. The largest customer accounted for sales of approximately \$5.7 million or approximately 29% of revenue.

## 8. Warranty Accrual

The Company generally warrants its products for a specific period of time against material defects. The Company provides for the estimated future costs of warranty obligations in costs of goods sold when the related revenue is recognized. The accrued warranty costs represent the best estimate at the time of sale of the total costs that the Company expects to incur to repair or replace product parts which fail while still under warranty. The amount of accrued estimated warranty costs is primarily based on historical experience as to product failures as well as current information on repair costs. The following table reflects the change in the Company's warranty accrual during the nine months ended September 30, 2003 (in thousands):

	September 30, 2003
Warranty accrual, beginning of period	\$130
Additional warranty	-
Other Payments	<u>(76)</u>
Warranty accrual, end of period	<u>\$54</u>

## 9. Other

A foreign investment income tax credit is available to offset 51.4% of income taxes on the Company's foreign subsidiary and net operating loss carryforwards are available to offset current U.S. taxable income.

Intangible assets consisted of the following (in thousands):

	<u>September 30,</u> <u>2003</u>	<u>December 31,</u> <u>2002</u>
Intangible assets of acquired businesses .....	\$ 2,400	\$ 2,400
Less: accumulated amortization.....	<u>(2,002)</u>	<u>(1,813)</u>
	<u>\$ 398</u>	<u>\$ 587</u>

In July 2003, the Company realized a gain of approximately \$0.4 million from a legal settlement. Under the terms of the settlement, the Company was released from certain liabilities in the amount of approximately \$0.3 million and received cash in the amount of \$0.04 million.

## 10. Financings

In June and July 2003, the Company issued bridge loans to certain investors in the amount of \$0.3 million. In connection with these bridge loans, the Company issued warrants to purchase 130,375 shares of common stock with an exercise price of \$1.65 per share. The warrants are exercisable beginning in November 2003 and expire in November 2004. The fair value of the warrants, calculated using the Black-Scholes option pricing model, totaling \$0.1 million, was recorded as a discount on the loans and accreted to interest expense.

In July 2003, the Company sold 1,293,643 common stock units in a private placement resulting in net proceeds of \$1.6 million, including the conversion of the bridge loans issued in June and July 2003. Each unit consists of one share of common stock and one warrant to purchase one share of common stock at an exercise price of \$2.80 per share. The warrants are exercisable beginning in January 2004 and expire in July 2006. The Company has the right to redeem any unexercised warrants for \$0.10 per warrant upon 30 days notice, if the underlying shares have been registered and the Company's common stock has a closing sales price over \$3.50 per share for the ten consecutive trading days on the Nasdaq SmallCap Market. In connection with the private placement, the Company issued 129,364 warrants to purchase the common stock units issued in the private placement at \$1.40 per share to the placement agent. The warrants are exercisable on the earlier of January 8, 2004 or the effective date of the registration statement covering the resale of the common stock and expire in July 2006.

## **11. Subsequent Events**

In November 2003, the Company extinguished certain liabilities totaling \$0.7 million by issuing approximately 294,000 shares of common stock.

## **Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

The following discussion should be read in conjunction with the Consolidated Financial Statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2002 and the condensed consolidated financial statements and notes thereto included herein for the three months and nine months ended September 30, 2003. Except for historical information, the following discussion contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, that involve risks and uncertainties, including, without limitation, statements with respect to the Company's strategy, expected operating results, including gross margins and return to profitability, proposed introduction of new products, including anticipated features, functionality and timing thereof, expected impact on our gross margins for such new product introductions, sales of the Company's products, the markets for the Company's products, and the development of the Company's products. The Company's actual results may differ materially from those described in these forward-looking statements due to a number of factors, including, but not limited to, faster than expected declines in the average selling prices of our products, the uncertainty of market acceptance of DVD loaders and other Company products, continued availability of working capital as the need to extend credit terms becomes more commonplace, planned growth of the Company's operations, dependence on a limited number of suppliers of certain components used in the Company's operations, risks associated with rapid technological change and obsolescence and product development, timeliness of new product introductions, conducting business in foreign countries, such as China, South Korea and India, the competitive market for the Company's products and other factors described in this report under "Factors That May Affect Future Results," as well as in the Form 10-K for the year ended December 31, 2002 and the Form 10-Q for the three months ended March 31, 2003 and the Form 10-Q for the three months and six months ended June 30, 2003 or in other documents the Company has filed from time to time with the Securities and Exchange Commission. A significant portion of the Company's revenue and net income is derived from international sales, particularly from customers based in Asia. Fluctuation of the U.S. dollar against foreign currencies and changes in local regulatory or economic conditions, among other things, could adversely affect operating results.

### **Results of Operations**

During the quarter ended September 30, 2003, the average unit selling price of DVD loaders sold to OEM DVD player manufacturers continued to decline to a level at which the Company determined that it would no longer be able to generate acceptable margins on these products. Accordingly, the Company has focused on developing products with higher margins. Our customers also experienced severe pricing pressures and in several cases initiated their own DVD loader manufacturing operations. Two of our largest customers began producing DVD loaders during the second quarter of 2003. However, to date, we have still been supplying sub assemblies, such as mechanisms and/or printed circuit boards, to these companies. These sub-assemblies have a unit selling price that is significantly lower than an assembled DVD loader but have a much higher rate of gross margin. To a certain extent, we have migrated our product offerings to these sub assemblies during the quarter ended September 30, 2003. However, we expect to continue to identify high end users, such as home theater system providers, that will pay a premium for the increased functionality and reliability of our DVD loader products. For the reasons stated above, during the quarter ended September 30, 2003 and despite the continuing decline in revenue, our rate of gross margin increased to higher than 10%. We anticipate that our margins

will continue to improve as we expect to introduce new products with the potential for higher margins in the fourth quarter of 2003.

The table below summarizes the Company's financials (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2003	2002	2003	2002
Revenue .....	\$19,677	\$47,756	\$70,603	\$113,182
Gross profit .....	2,208	4,572	5,770	10,424
(Loss) income from operations .....	(1,309)	1,474	(5,467)	1,110
Net (loss) income .....	(1,596)	1,847	(4,494)	(951)

We anticipate that revenues in the fourth quarter of 2003 will be significantly less than revenues for the same period a year ago. We expect sales of new products with stronger margins to begin in late October 2003. In light of our expected improvements in gross margins and the further reductions anticipated in our operating expenses, we expect that our operating results for the fourth quarter of 2003 will improve, as compared to the first three quarters of 2003.

### The Three Months Ended September 30, 2003 Compared to the Three Months Ended September 30, 2002

The following table sets forth for the periods indicated certain income and expense items expressed as a percentage of the Company's total revenue for the three month period ended September 30, 2003 compared with the three month period ended September 30, 2002. See Consolidated Statements of Operations and related notes thereto for additional details.

Percent of Revenue	Three Months Ended September 30,	
	2003	2002
Revenue .....	100.0%	100.0%
Gross margin .....	11.2%	9.6%
Research and development .....	6.9%	2.0%
Sales and marketing .....	3.2%	1.9%
General and administration .....	7.7%	2.7%
(Loss) income from operations .....	(6.6)%	3.1%
Net (loss) income .....	(8.1)%	3.9%

Consolidated Revenue	Three Months Ended September 30,		% Change
	2003	2002	
Amount (in thousands) .....	\$ 19,677	\$ 47,756	(59%)

Total revenue decreased by \$28.0 million, or 59%, for the three months ended September 30, 2003 as compared with the three months ended September 30, 2002. This decrease is primarily attributable to a significant overall decrease in demand for DVD loaders from two of our major customers following the commencement of their own DVD loader production operations. These customers began procuring only sub-assemblies from the Company which resulted in significantly lower revenues in the quarter ended September 30, 2003. Most notably, Vestel who purchased our DVD loaders for a total of approximately \$30 million in 2002 has reduced their procurement of our DVD loaders to \$10.5 million through September 30, 2003. In addition, we estimate total procurement from Vestel to be less than \$12 million for the year 2003.

In the three months ended September 30, 2003, sales in China were approximately \$2.4 million or 10% of revenue as compared with \$8.3 million or 70% of revenue for the three months ended September 30, 2002. This

decrease in revenue in China is partly attributable to a decrease in the volume of loaders shipped as compared to the same period a year ago, and to a much greater extent a significant decrease in the average unit selling price of our products. During the three months ended September 30, 2003, Ellion Digital Inc. accounted for approximately 29% of our total sales.

<b>Gross Profit</b>	<b>Three Months Ended September 30,</b>		<b>% Change</b>
	<b>2003</b>	<b>2002</b>	
Amount (in thousands).....	\$ 2,208	\$ 4,572	(52%)
As a percentage of revenue.....	11.2%	9.6%	—

During the three months ended September 30, 2003, gross margin was \$2.2 million or 11.2% of revenue, as compared to \$4.6 million or 9.6% of revenue for the three months ended September 30, 2002. We expect that our gross margins will improve in the future. In this regard, our new product engineering group in South Korea is currently developing DVD players for the automotive market and rewritable drives that we expect will provide higher rates of gross margin. Working prototypes of both these products were shown at our Korean subsidiary's annual meeting in March 2003. We anticipate that the introduction of these products will occur in the fourth quarter of 2003. Our development efforts are ongoing and we expect to continue product development in future periods.

<b>Research and Development</b>	<b>Three Months Ended September 30,</b>		<b>% Change</b>
	<b>2003</b>	<b>2002</b>	
Amount (in thousands).....	\$ 1,364	\$ 953	43%
As a percentage of revenue.....	6.9%	2.0%	—

Research and development expenses consist primarily of personnel and equipment prototype costs required for our product development efforts. Research and development spending in this quarter increased to 6.9% of revenue, compared with 2.0% of revenue in the corresponding quarter a year ago. This increase is primarily attributable to new product development initiated both in South Korea and in the United States by MobileTouch Korea, a wholly owned subsidiary of DVS Korea, and MobileTouch USA, a wholly owned subsidiary of the Company. These subsidiaries working in partnership with Jeecom, Inc. are developing new products and applications directed at the corporate and consumer mobile applications market, with a particular focus on media rich applications for the consumer market. As of September 30, 2003, our developments efforts are ongoing and we expect to continue these programs in the future. Additionally, DVSK our subsidiary in Korea has been actively engaged in developing DVD products for the automotive market and DVD+RW recordable loader products.

<b>Sales and Marketing</b>	<b>Three Months Ended September 30,</b>		<b>% Change</b>
	<b>2003</b>	<b>2002</b>	
Amount (in thousands).....	\$ 634	\$ 879	(28%)
As a percentage of revenue.....	3.2%	1.9%	—

Sales and marketing expenses consist primarily of personnel and consulting costs related to our sales process and the marketing of our products, as well as sales commissions and expenses related to promotional activities. Sales and marketing expenses for the three-month period ended September 30, 2003 decreased in dollar terms by \$0.2 million, or a 28% decrease from the corresponding quarter of 2002. The decrease reflects spending reductions in our sales activities to adjust to current revenue. Notwithstanding an overall decrease in sales and marketing expenses, we have maintained or increased certain marketing activities necessary for new product introductions such as, DVD players, rewritable drives, and audio-video loaders and players for the automotive market.

<b>General and Administrative</b>	<b>Three Months Ended September 30,</b>		<b>% Change</b>
	<b>2003</b>	<b>2002</b>	
Amount (in thousands).....	\$ 1,519	\$ 1,266	20%
As a percentage of revenue.....	7.7%	2.7%	—

General and administrative expenses consist of administrative salaries, bonuses and benefits, insurance, facility leases, fees for legal and accounting services, investor relations and other related costs. General and administrative expenses in the quarter ended September 30, 2003 increased by \$0.25 million, or 20%, as compared to the corresponding quarter in 2002. The increase general and administrative spending consisted of \$0.1 million related to establishment of our offices in Bangalore, India, and additional general and administrative spending related to our joint venture in China of \$ 0.1 million.

<b>Other Income / (Expense)</b>	<b>Three Months Ended September 30,</b>	
	<b>2003</b>	<b>2002</b>
Amount (in thousands).....	\$ (732)	\$ 1,503
As a percentage of revenue.....	(3.7%)	3.1%

Other expense of \$0.7 million in the three months ending September 30, 2003 consists primarily of an exchange loss of \$1.1 million offset by the favorable settlement of certain litigation totaling \$0.4 million. In the three months ended September 30, 2002 other income principally consisted of exchange rate gains of \$1.1 million, and \$0.4 million generated from an increase in value of the common stock held by the Company as collateral for a related party note receivable.

#### **The Nine Months Ended September 30, 2003 Compared with the Nine Months Ended September 30, 2002**

The following table sets forth certain income and expense items expressed as a percentage of the Company's total revenue for the nine-month period ended September 30, 2003 compared to the corresponding period in 2002. See Condensed Consolidated Statements of Operations.

<b>Percent of Revenue</b>	<b>Nine Months Ended September 30,</b>	
	<b>2003</b>	<b>2002</b>
Revenue .....	100.0%	100.0%
Gross margin.....	8.2%	9.2%
Research and development .....	5.7%	2.3%
Sales and marketing .....	3.1%	1.8%
General and administration.....	7.1%	4.1%
(Loss) Income from operations.....	(7.7%)	1.0%
Net (loss) income.....	(6.4%)	(0.8%)

<b>Consolidated Revenue</b>	<b>Nine Months Ended September 30,</b>		<b>% Change</b>
	<b>2003</b>	<b>2002</b>	
Amount (in thousands).....	\$ 70,603	\$ 113,182	(38%)

Total revenue decreased by \$42.6 million, or 38%, for the nine months ended September 30, 2003 compared with the nine months ended September 30, 2002. This decrease is partly attributable to a decrease in the volume of loaders shipped as compared to the same period a year ago, and to a much greater extent, a significant decrease of over 20% in the average unit selling price of our DVD loaders.

In the nine months ended September 30, 2003, sales in China were approximately \$10.3 million, or 15% of revenue, as compared to \$124.0 million, or 79% of revenue for the same period a year ago. This decrease in revenue in China is partly attributable to a decrease in the volume of loaders shipped as compared to the same period a year ago, and to a much greater extent a significant decrease in the average unit selling price of our products.

<b>Gross Profit</b>	<b>Nine Months Ended September 30,</b>		<b>% Change</b>
	<b>2003</b>	<b>2002</b>	
Amount (in thousands).....	\$ 5,770	\$ 10,424	(45%)
As a percentage of revenue.....	8.2%	9.2%	

During the nine months ended September 30, 2003, gross margin was \$5.8 million or 8.2% of revenue, as compared to \$10.4 million, or 9.2% of revenue for the nine months ended September 30, 2002. This decline in gross margin is primarily attributable to the decrease in the average unit selling price of our products during the nine months ended September 30, 2003. Margins have decreased during the nine months ended September 30, 2003 primarily due to the continued pricing pressures on our DVD loader unit. To some extent, sales of higher margin products, such as sub-assemblies, in the second and third quarters of 2003 have moderated the impact of the downward pricing pressure on our DVD loaders for the nine months ended September 30, 2003.

<b>Research and Development</b>	<b>Nine Months Ended September 30,</b>		<b>% Change</b>
	<b>2003</b>	<b>2002</b>	
Amount (in thousands).....	\$ 4,033	\$ 2,640	53%
As a percentage of revenue.....	5.7%	2.3%	

Research and development expenses consist primarily of personnel and equipment prototype costs required for our product development efforts. Research and development spending during the nine months ended September 30, 2003 increased to 5.7% of revenue, compared with 2.3% of revenue for the corresponding period a year ago. This increase is primarily attributable to new product development initiated both in South Korea and in the United States by MobileTouch Korea, a wholly owned subsidiary of DVS Korea and MobileTouch USA, a wholly owned subsidiary of the Company. These subsidiaries are developing new products and applications directed at the corporate and consumer mobile applications market, with a particular focus on media rich applications for the consumer market. Additionally, DVSK our subsidiary in Korea has been actively engaged in developing DVD products for the automotive market and DVD+RW recordable loader products.

<b>Sales and Marketing</b>	<b>Nine Months Ended September 30,</b>		<b>% Change</b>
	<b>2003</b>	<b>2002</b>	
Amount (in thousands).....	\$ 2,196	\$ 2,001	10%
As a percentage of revenue.....	3.1%	1.8%	—

Sales and marketing expenses consist primarily of personnel costs related to our sales process and the marketing of our products, as well as sales commissions and expenses related to promotional activities. Sales and marketing expenses for the nine-month period ended September 30, 2003 increased by \$0.2 million, or a 10% increase from the corresponding period of 2002. This increase in sales and marketing spending, as a percentage of revenue, due to lower levels of revenue for our DVD loaders. However, we expect our sales and marketing expenses to continue at approximately the same level in absolute dollar terms through 2003, as we continue to sell and market new products.

<b>General and Administrative</b>	<b>Nine Months Ended September 30,</b>		<b>% Change</b>
	<b>2003</b>	<b>2002</b>	
Amount (in thousands).....	\$ 5,008	\$ 4,673	7%
As a percentage of revenue.....	7.1%	4.1%	—

General and administrative expenses consist of administrative salaries, bonuses and benefits, insurance, facility leases, fees for legal and accounting services, investor relations and other related costs. General and administrative expenses during the nine months ended September 30, 2003 increased by \$0.3 million over the corresponding period in 2002, of which \$0.3 million was the build up of our China operation and the remaining increase from the setup of our Mobile Touch subsidiaries. The increase in general and administrative expenses as a percentage of revenue is primarily attributable to the decrease in revenue during the nine months ended September 30, 2003. We expect to reduce our general and administrative expenses during the fourth quarter of 2003.

## Liquidity and Capital Resources

At September 30, 2003, the Company had \$14.5 million of cash and equivalents, of which \$6.2 million was restricted as collateral for lines of credit. Working capital declined slightly from \$7.6 million at June 30, 2003 to \$7.5 million at September 30, 2003. At December 31, 2002, the Company had working capital of \$11.4 million.

Net cash used in operating activities was \$5.1 million for the nine months ended September 30, 2003 as compared with \$20.2 million used in operating activities in the nine months ended September 30, 2002. Cash was provided as accounts receivable declined by \$2.8 million, non-cash charges for depreciation and amortization amounted to \$2.1 million, and the forgiveness of accounting and legal fees in connection with legal settlement by \$0.3 million. The use of cash by operating activities was attributable to net losses of \$4.5 million, with an increase in inventories and prepaid expenses and other current assets by \$0.7 million and \$0.3 million, respectively, a decrease in accounts payable of \$2.4 million, a non-cash change in minority interest of \$1.8 million, in changes to the valuation allowances for notes and accounts receivable of \$0.4 million, and in the changes of deferred tax assets of \$0.3 million.

The decline of accounts receivable of \$2.8 million was attributable to a decrease in revenues in the recent quarter ended September 30, 2003, as compared to the comparable period in the prior year. Inventories increased by \$0.7 million. Reductions in inventory are anticipated in the fourth quarter consistent with our expected level of operations.

Net cash used in investing activities was \$3.4 million for the nine months ended September 30, 2003, which primarily consisted of an increase in restricted cash of \$0.3 million and the acquisition of property and equipment for \$3.1 million. Tooling for new products in the quarter ended September 30, 2003 totaled \$1.0 million and building and leasehold improvements to the new production facilities in South Korea and China totaled \$1.2 million. The remaining \$0.9 million was attributable to investments in factory and computer equipment.

Net cash provided by financing activities was \$3.7 million for the nine months ended September 30, 2003, as compared to \$29.7 million during the nine months ended September 30, 2002. The cash provided by financing activities in this period was primarily borrowings of \$1.6 million from a line of credit (Korea), \$0.8 million from notes payable (China), \$1.1 million in proceeds from sales of shares of common stock and the exercise of options and warrants (U.S.). Our cash obtained from financing activities for the comparable period a year ago consisted of borrowings of \$19.0 million by our Korean subsidiary under credit lines and proceeds of \$10.7 million from the Initial Public Offering of our subsidiary DVSK.

Inventory turn and receivables turn from the previous twelve-month periods were as follows:

	<b>Twelve Months Ended September 30, 2003</b>	<b>Twelve Months Ended December 31, 2002</b>
Inventory turn.....	4.2 X	8.3 X
Receivable turn.....	12.3 X	24.6 X

We currently expect that for the year ended 2003, our inventories will turn at a much lower rate than in the previous twelve-month period. This change in expectation is due to the greater than expected reductions of our revenue levels. We expect receivable turns in the year 2003 to be significantly lower than in the previous twelve-month period due to the current competitive market that would require the Company to extend open credit terms to maintain and attract customers.

In February 2003, the Company made a strategic relocation of its main manufacturing plant in China to a new site in the Shanghai Jinqiao Export Processing Zone (EXZ). The new facility offers approximately 123,000 square feet of space. The monthly rent obligation will be \$27,549, or approximately \$0.23 per square foot. We expect that the monthly operating expenses at the new facility will be approximately \$2,754, or approximately \$0.02 per square foot.

The new lease offers 50% more square footage than the former plant at the same or lower cost. The term is 3 years and the total future minimum lease payment under this lease was \$0.9 million at September 30, 2003.

We believe that with working capital of \$7.5 million at September 30, 2003, and the renewal of our existing lines of credit in South Korea, now totaling \$48 million of which we have taken down \$27.7 million, that our operations in Asia have sufficient resources to execute both our new product plans and satisfy production requirements for the year 2003. In July 2003, we sold shares of our common stock in a private offering that raised proceeds of approximately \$1.6 million, net of issuance cost. We expect that our operations in the U.S. will require the raising of additional capital to finance our operations in the U.S. and provide funding for the development of new products and applications. Additionally, the Company is in the process of raising money for its newly formed wholly owned Indian subsidiary, DVS Electronics Pvt. Ltd. (DVSE) and we expect that additional capital raising activities will be necessary to fund our operations in India in future periods.

### **FACTORS THAT MAY AFFECT FUTURE RESULTS**

In addition to the other information contained in this Form 10-Q, we have identified the following risks and uncertainties that may have a material adverse affect on our business, financial condition or results of operation. *This section should be read in conjunction with the audited Consolidated Financial Statements and Notes thereto, and Management's Discussion and Analysis of Financial Condition and Results of Operations contained in this Form 10-Q.*

**Our operating results fluctuate significantly, and an unanticipated decline in revenue or earnings may disappoint investors or securities analysts and result in a decline in our stock price.**

In addition to the losses incurred in the nine months ended September 30, 2003 and during the year ended December 31, 2002, we have incurred substantial net losses in the past, as recently as, among others, fiscal years ended March 31, 1999, 1998 and 1997. We also expect to generate losses as we invest heavily in R&D personnel and engineers in connection with our research and development efforts related to new product development during 2003. Our recent quarterly and annual operating results have fluctuated, and will continue to fluctuate, due to the following factors, all of which are difficult to forecast and many of which are not within our control:

- the availability, timely delivery and cost of components from our suppliers;
- competitive pressures and related changes in selling prices;
- fluctuations in manufacturing yields and significant yield losses which affect our ability to fulfill orders;
- recent trends by current and former customers to implement their own DVD loader manufacturing operations, and whether entities that do so continue to buy sub-assemblies from us.
- new product announcements and introductions for competing products by us or our competitors;
- the rate at which our products become obsolete;
- unpredictability of changes in demand for, or in the mix of, our products;
- the gain or loss of significant customers;
- market acceptance of products utilizing our technologies;
- changes in the channels through which our products are distributed and the timeliness of receipt of distributor resale information;
- exchange rate fluctuations;

- general economic, political and environmental-related conditions, such as natural disasters;
- difficulties in forecasting, planning and management of inventory levels, which may trigger lower of cost or market inventory adjustments;
- unanticipated research and development expenses associated with new product introductions;
- the timing of significant orders and of license and royalty revenue; and
- the seasonality in our business.

A downturn in the market for consumer products such as personal computers and DVD players that incorporate our products can also harm our operating results. In addition, some of our customers may place orders at or near the end of a quarter. As a result, we may not learn of revenue shortfalls until late in a quarter and may not be able to predict future revenues with accuracy. Additionally, a large portion of our costs consists of salaries for personnel and materials that must be ordered several months in advance. These costs are based in part on our expectations for future revenues and are relatively fixed in the short term. As a result, any revenue shortfall below expectations could harm our business.

**Our capital resources may not be sufficient to meet our capital requirements.**

Since our inception, we have periodically experienced negative cash flow from operations and could experience significant negative cash flow from operations in the future. Our current and future capital requirements are substantial and we cannot be certain that cash generated from operations will be sufficient or that financing will be available at favorable terms when required, or at all. If our capital resources are insufficient to meet future capital requirements, we may not meet our financial obligations to our creditors when they become due or we may have to curtail or cease certain operations.

**We depend on a limited number of foreign suppliers to manufacture certain key components, and these manufacturers may not be able to satisfy our requirements, which could cause our revenues to decline.**

We currently buy certain key components, including optical pick-ups, motors, central processing units and certain other integrated circuits from a limited number of suppliers including, Zoran, Mediatech, and Hitachi. We anticipate that these suppliers will manufacture sufficient quantities of these key components to meet our production requirements. If these suppliers fail to satisfy our requirements on a timely basis and at competitive prices, we could suffer manufacturing delays, a possible loss of revenues or higher than anticipated costs of revenues, any of which could seriously harm our operating results. Any constraints on worldwide manufacturing capacity of these key components may affect our ability to obtain adequate supplies from these manufacturers. Although our on-going relationships with our key suppliers are material in the aggregate, we do not have any specific agreement with any supplier that is material to our business. We purchase materials from suppliers on an as-needed basis through individual purchase orders, none of which is material to our business or results of operations. In certain instances, we have failed to meet the demand for our products or the scheduled shipment dates due to our inability to obtain a sufficient supply of certain key components from our suppliers. The suppliers with which we currently are working with, together with any additional supplier at which capacity might be obtained, may not be willing or able to satisfy all of our manufacturing requirements on a timely basis at favorable prices. In addition, we have encountered delays in qualifying new products and increasing new product production and could experience these delays in the future. We are also subject to the risks of service disruptions, raw material shortages and price increases by our suppliers. Such disruptions, shortages and price increases could seriously harm our operating results.

**If we are unable to increase our manufacturing capacity, we may not achieve our planned growth.**

Notwithstanding our recent expansion efforts, in order to grow, we need to increase our present manufacturing capacity. Events that we have not foreseen could arise which would limit our manufacturing capacity. In addition, if we cannot satisfactorily increase our manufacturing capacity, our ability to grow will be severely impaired and this may harm our operating results.

**Our financing requirements will increase in order to obtain additional manufacturing capacity in the future.**

To obtain additional manufacturing capacity, we may be required to make deposits, equipment purchases, loans, joint ventures, equity investments or technology licenses in or with other companies. These transactions could involve a commitment of substantial amounts of our capital and technology licenses in return for production capacity. We may be required to seek additional debt or equity financing if we need substantial capital in order to secure this capacity and we cannot assure you that we will be able to obtain such financing on terms acceptable to us, if at all.

**If we or our suppliers fail to achieve acceptable manufacturing yields, we will experience higher costs of revenues and reduced product availability.**

The fabrication of our products requires certain components produced in a highly controlled and clean environment. Companies that supply our components sometimes have experienced problems achieving acceptable manufacturing yields. Low yields may result from marginal design or manufacturing process drift. Yield problems may not be identified until the components are well into the production process, which often makes them difficult, time consuming and costly to correct. Furthermore, we rely on overseas suppliers of certain key components, which increases the effort and time required to identify, communicate and resolve manufacturing yield problems. If our suppliers fail to achieve acceptable manufacturing yields, we will experience higher costs of revenues and reduced product availability, which would harm our operating results.

**If our suppliers discontinue the manufacturing processes or lines needed to meet our demands, or fail to upgrade the technologies needed to manufacture our products, we may face production delays and lower revenues.**

Our products' requirements may represent a small portion of the total production of the suppliers that manufacture our components. As a result, we are subject to the risk that a supplier may cease production on an older or lower-volume manufacturing process that it uses to produce our parts. Additionally, we cannot be certain our suppliers will continue to devote resources to advance the production technologies on which the manufacturing of our parts is based. Each of these events could increase our costs and harm our ability to deliver our products on time.

**Our growth and future profitability depend upon our ability to successfully develop and commercialize new DVD products.**

During the last three years, a substantial amount of revenues have been generated by the DVD product line, which is central to our growth strategy. The market for this line of products has experienced intense competition and is highly price sensitive. The average unit selling price for our DVD loader products has decreased and we expect it to continue to decrease in the foreseeable future. Unless we obtain an equally reduced cost of revenues, our gross margins will continue to decline. Successful development and commercialization of new products is essential to our growth and future profitability. While we are currently developing and introducing new products in this product line, we cannot assure you that these products will reach the market in a timely manner, satisfactorily address customer needs, be sold in high volume, or be sold at profitable margins. In addition, we expect to generate losses as we invest heavily in R&D personnel and engineers during 2003.

**Our operating expenses are relatively fixed, and we order materials in advance of anticipated customer demand; therefore, we have limited ability to reduce expenses quickly in response to any revenue shortfalls.**

Our operating expenses are relatively fixed, and we therefore have limited ability to reduce expenses quickly in response to any revenue shortfalls. Consequently, our operating results will be harmed if our revenues do not meet our revenue projections. We may experience revenue shortfalls for the following reasons:

- significant pricing pressures that occur due to competition, over-supply, or other reasons;
- sudden shortages of raw materials or fabrication, test or assembly capacity constraints that lead our suppliers to allocate available supplies or capacity to other customers which, in turn, harm our ability to meet our sales obligations; and
- the reduction, rescheduling or cancellation of customer orders.

In addition, we typically plan our production and inventory levels based on customers' advance orders, commitments or forecasts, as well as our internal assessment and forecasts of customer demand, which are highly unpredictable and can fluctuate substantially, especially if competition becomes more intense or the demand is reduced due to seasonal or other factors. From time to time, in response to anticipated long lead times to obtain inventory and materials from our suppliers, we may order materials in advance of anticipated customer demand. This advance ordering may result in excess inventory levels or unanticipated inventory write-downs if expected orders fail to materialize.

**Because our products typically have lengthy sales cycles, we may experience substantial delays between incurring expenses related to research and development and the generation of revenues.**

It usually requires a number of months to realize volume shipments after we first contact a customer. We first work with customers to achieve a design win, which may take months or longer. Our customers then complete the design, testing and evaluation process and begin to ramp up production, over a period which typically lasts months or longer. As a result, a significant period of time may elapse between the time we incur expenses from our research and development efforts and our realization of revenue, if any, from volume purchasing of our products by our customers.

**We face intense competition from companies with significantly greater financial, technical and marketing resources that could adversely affect our ability to maintain or increase sales of our products.**

We compete with major international electronics companies, many of which have substantially greater financial, technical, marketing, distribution, and other resources than we do. Many of our competitors have their own facilities for the production of semiconductor components and have been active in increasing their market shares and their capacity for the production of competing products. Our DVD products presently account for substantially all of our revenues. Our competitors or potential competitors include Hitachi, Toshiba, Sony, Pioneer, Teac, Sanyo, Samsung, Philips, LG, and many others. Some of our competitors or potential competitors are also suppliers of key components for some of our products. In these cases, our competitors may have divisions making competing DVD products that have access to some of our proprietary information through the divisions supplying components to us, or exert influence on the parts supplying divisions in ways that may adversely affect our parts supply. These actions would adversely affect our competitiveness and sales. Competition may also come from alternative technologies being developed by these companies.

**Our markets are subject to rapid technological change and, therefore, our success depends on our ability to develop and introduce new products.**

The markets for our products are characterized by:

- rapidly changing technologies;
- evolving and competing industry standards;
- changing customer needs;
- frequent new product introductions and enhancements;
- increased integration with other functions; and
- rapid product obsolescence.

To develop new products for our target markets, we must develop, gain access to and use leading technologies in a cost-effective and timely manner and continue to expand our technical and design expertise. In addition, we must have our products designed into our customers' future products and maintain close working relationships with key customers in order to develop new products that meet their changing needs. In addition, DVD products involve continually evolving industry standards. Our ability to compete will depend on our ability to identify and ensure compliance with these industry standards. As a result, we could be required to invest significant time and effort and incur significant expense to redesign our products and ensure compliance with relevant standards. We cannot assure you

that we will be able to identify new product opportunities successfully, develop and bring to market new products, achieve design wins or respond effectively to new technological changes or product announcements by our competitors. In addition, we may not be successful in developing or using new technologies or in developing new products or product enhancements that achieve market acceptance. Our pursuit of necessary technological advances may require substantial time and expense. Failure in any of these areas could harm our operating results.

**Our future success depends in part on the continued service of our key design engineering, sales, marketing and executive personnel and our ability to identify, recruit and retain additional personnel.**

We are highly dependent on our principal management and engineering staff. There is intense competition for qualified personnel in our industry, in particular the highly skilled technical personnel involved in the development of DVD technologies and the production of DVD products. Competition is especially intense in Silicon Valley, where our corporate headquarters are located, and in South Korea, where our DVD products have been designed and where most of our manufacturing takes place. We may not be able to continue to attract and retain engineers or other qualified personnel necessary for the development of our business or to replace engineers or other qualified personnel who may leave our employ in the future. Our anticipated growth is expected to place increased demands on our resources and will likely require the addition of new management and engineering personnel and the development of additional expertise by existing management personnel. The failure to recruit and retain key technical and management personnel could harm our business.

**Our ability to compete successfully will depend, in part, on our ability to protect our intellectual property rights, and we may be unable to do so.**

We rely on a combination of patent, trade secrets, copyright and mask work production laws and rights, nondisclosure agreements and other contractual provisions and technical measures to protect our intellectual property rights. Policing unauthorized use of our products, however, is difficult, especially in foreign countries, such as China and South Korea, where the laws may not protect our proprietary rights as fully as in the United States. Litigation may continue to be necessary in the future to enforce our intellectual property rights, to protect our trade secrets, to determine the validity and scope of the proprietary rights of others, or to defend against claims of infringement or invalidity. Litigation could result in substantial costs and diversion of resources and could harm our business, operating results and financial condition regardless of the outcome of the litigation. We have acquired ownership or license to a number of patents or patent applications related to our products. However, we cannot assure you that any pending patent application will be granted, or that such patents will provide adequate protection for our intellectual property. Since our competitors may design around our patents or otherwise independently develop competing technology, our operating results would be seriously harmed by the failure to protect our intellectual property.

**If we are accused of infringing the intellectual property rights of other parties we may become subject to time-consuming and costly litigation. If we lose such litigation, we could suffer a significant impact on our business and be forced to pay damages.**

Third parties may assert that our products infringe their proprietary rights, or may assert claims for indemnification resulting from infringement claims against us. Any such claims may cause us to delay or cancel shipment of our products or pay damages, which could seriously harm our business, financial condition and results of operations. In addition, irrespective of the validity or the successful assertion of such claims, we could incur significant costs in defending against such claims. In addition, we receive from time to time letters or communications from other companies stating that such companies have patent rights relating to our products. Any legal finding that we infringe the patent of another company would have a significantly negative effect on our operating results. Furthermore, if such a finding were made, there can be no assurance that we could license the other company's technology on commercially reasonable terms or that we could successfully operate without such technology. Moreover, if we are found to infringe, we could be required to pay damages to the owner of the protected technology and could be prohibited from making, using or selling any products that infringe the protected technology. In addition, the management attention consumed by and legal cost associated with any litigation could have a negative effect on our operating results. During the course of lawsuits there may be public announcements of the results of hearings, motions, and other interim proceedings or developments in the litigation. If securities analysts or investors perceive these results to be negative, it could have a substantial negative effect on the trading price of our stock. Whether or not we are successful in any litigation, we expect the litigation to consume substantial amounts of our financial and managerial resources. Further, because of the

substantial amount of discovery required in connection with this type of litigation, there is a risk that some of our confidential information could be compromised by disclosure.

**General economic conditions may reduce our revenues and harm our business.**

As our business has grown, we have become increasingly subject to the risks arising from adverse changes in domestic and global economic conditions. Because of the recent economic slowdown in the United States, many industries are delaying or reducing technology purchases. The impact of this slowdown on us is difficult to predict, but it may result in reductions in purchases of products by our end-user customers, longer sales cycles and increased price competition. As a result, if the current economic slowdown continues or worsens, we may fall short of our revenue expectations for any given quarter in 2003 or for the entire year.

**Our business may suffer due to risks associated with international sales and operations.**

Sales of products overseas accounted for 90.8%, 99.7%, 98.1%, 99.0% and 99.5% of our revenues in the fiscal year ended March 31, 2000, the nine-month period ended December 31, 2000, the fiscal year ended December 31, 2001, the fiscal year ended December 31, 2002 and the nine-month period ended September 30, 2003, respectively. Our international business activities are subject to a number of risks, each of which could impose unexpected costs on us that would have an adverse effect on our operating results. These risks include:

- difficulties in complying with foreign regulatory requirements and standards;
- tariffs and other trade barriers relating to cross border transactions;
- costs and risks of localizing products for foreign countries;
- longer accounts receivable payment cycles from customers located in foreign countries;
- potentially adverse tax consequences resulting from changes in international tax regulations;
- limits on repatriation of earnings from our foreign operations; and
- limited ability to effect quality-control measures associated with our foreign operations.

We derived most of our product revenue from Asia during the last three years. Additionally, our major suppliers and assembly subcontractors are all located in Asia. Any kind of economic, political or environmental instability in this region of the world can have a severe negative impact on our operating results due to the large concentration of our production and sales activities in this region. For example, during 1997 and 1998, several Asian countries where we currently do business, such as Japan, Taiwan and South Korea, experienced severe currency fluctuation and economic deflation. If such situations reoccur, it may negatively impact our total revenues and our ability to collect payments from customers in these regions. During such situations, the lack of capital in the financial sectors of these countries can make it difficult for our customers to open letters of credit or other financial instruments that are guaranteed by foreign banks. Finally, the economic situation during such periods may exacerbate a decline in selling prices for our products as our competitors may reduce product prices to generate needed cash.

In addition, we are greatly impacted by the political, economic and military conditions in Taiwan and China, and North Korea and South Korea, which are continuously engaged in political disputes. These countries have conducted military exercises in or near the other's territorial waters and airspace. Such disputes may continue and even escalate, resulting in an economic embargo, a disruption in shipping or even military hostilities. This could severely harm our business by interrupting or delaying production or shipment of our products. Any kind of activity of this nature or even rumors of such activity could severely negatively impact our operations, revenues, operating results, and stock price.

**We may encounter significant difficulties in understanding local business practices that may require additional expenditures.**

As a substantial portion of our operations are located in Asia and subject to foreign laws and regulations, our operations in Asia may be adversely affected by changes in local laws and regulations, such as those relating to accounting practices, taxation, import and export tariffs, environmental regulations, land use rights, property and other matters. Local governments may impose new, stricter regulations or interpretations of existing regulations, which would require additional expenditures. Asian economies may also differ in terms of structure, government involvement, level of development, growth rate, capital reinvestment, allocation of resources, self-sufficiency and rate of inflation, among others. As a result, we may encounter significant difficulties in understanding and addressing local business practices that may require us to incur additional expenses in connection with our international operations.

**Because a small number of customers have accounted for, and are likely to continue to account for, a substantial portion of our revenues, our revenues could decline due to the loss of one of these customers.**

Products sold to our top five customers accounted for approximately 47% and 59% of our revenues during the year ended December 31, 2002 and the nine-month period ended September 30, 2003, respectively. Products sold to our top 10 customers accounted for approximately 75%, 88%, 67% and 77% of our revenues during the nine-month period ended December 31, 2000, the fiscal year ended December 31, 2001, the fiscal year ended December 31, 2002, and the nine-month period ended September 30, 2003, respectively. In the quarter ended September 30, 2003, Ellion Digital, Inc., Vestel, Malata, and GVG accounted for 29.2%, 13.9%, 13.5%, and 12.9% of our revenue, respectively. In the fiscal year ended December 31, 2002, Vestel accounted for 23% of our revenue. In the fiscal year ended December 31, 2001, SIIG accounted for about 37% of our revenue. In the fiscal year ended March 31, 2000, Hyundai accounted for about 36% of our revenue. In the nine-month period ended December 31, 2000, Hyundai accounted for about 42% of our revenue. No other customers accounted for more than 10% of our revenues during these three periods. If we were to lose any of these customers or experience any substantial reduction in orders from these customers, our revenues and operating results would suffer.

**We do not have long-term contracts with our customers and the loss of a major customer could seriously harm our business.**

We do not typically enter into long-term contracts with our customers, and we cannot be certain as to future order levels from our customers. When we do enter into a long-term contract, the contract is generally terminable at the convenience of the customer. An early termination by one of our major customers would harm our financial results, as it is unlikely that we would be able to rapidly replace that revenue source.

**Our backlog may not result in future revenue, which would seriously harm our business.**

Due to possible customer changes in delivery schedules and cancellations of orders, our backlog at any particular date is not necessarily indicative of actual sales for any succeeding period. A reduction of backlog during any particular period, or the failure of our backlog to result in future revenue, could harm our business.

**Business interruptions could adversely affect our business.**

Our operations are vulnerable to interruptions by fire, earthquake, power loss, telecommunications failure and other events beyond our control. We do not have a detailed disaster recovery plan. Our facilities in Northern California may be subject to electrical blackouts as a consequence of a shortage of available electrical power. In the event these blackouts occur, continue or increase in severity, they could disrupt the operations of our affected facilities. In connection with the shortage of available power, prices for electricity have risen dramatically, and may continue to increase for the foreseeable future. Such price changes will increase our operating costs, which could in turn hurt our profitability. In addition, we do not carry sufficient business interruption insurance to compensate us for losses that may occur, and any losses or damages incurred by us could harm our business.

**We may require additional capital in order to bring new products to market, and the issuance of new equity securities will dilute your investment in our common stock.**

To permit the growth of our business operations in the future, we need to expand our production capacity and bring new products to market, which will likely require significant working capital. We have established credit facilities with certain Korean banks with a total borrowing limit of about \$48 million as of September 30, 2003. We have also formed alliances with state-run businesses in China, which have committed to substantial amounts of trade credit and financing for production in China under certain terms. However, there is no assurance that these credit facilities will always be available. We may also need to sell shares of our common stock or seek additional borrowings or outside capital infusions in the future. We cannot assure you that such financing options will be available on terms acceptable to us, if at all. In addition, if we issue shares of our common stock, our shareholders will experience dilution with respect to their investment.

**Our growth continues to place a significant strain on our management systems and resources and if we fail to manage our growth, our ability to market and sell our products and develop new products may be harmed.**

Our business is experiencing rapid growth which has strained our internal systems and will require us to develop or adopt more sophisticated information management systems in order to manage the business effectively. Although we have implemented an ERP system, there is no guarantee that this system and any new systems implemented in the future will be adequate to address our expected growth, or that management will be able to foresee in a timely manner other infrastructure needs before they arise. Our success depends on the ability of our executive officers to effectively manage our growth. If we are unable to manage our growth effectively, our results of operations will be seriously harmed.

**The price of our common stock is likely to be volatile.**

Our stock has closed at prices ranging from a high of \$6.23 on December 11, 2001 to a low of \$1.08 on June 24, 2002. If our revenues do not grow or grow more slowly than we anticipate, or if operating or capital expenditures exceed our expectations or cannot be adjusted accordingly, the market price of our common stock could be materially and adversely affected. In addition, the market price of our common stock has been in the past and could in the future be materially and adversely affected for reasons unrelated to our specific business or results of operations. General market price declines or volatility in the future could adversely affect the price of our common stock. In addition, short-term trading strategies of certain investors can also have a significant effect on the price of specific securities.

**The exercise of warrants or options may depress our stock price.**

There are a significant number of warrants and options to purchase our common stock outstanding. Holders may sell the common stock acquired upon exercise of the warrants and options at a market price that exceeds the exercise price of the warrants and options paid by the holders. Sales of a substantial number of shares of common stock in the public market by holders of warrants or options may depress the prevailing market price for our common stock and could impair our ability to raise capital through the future sale of our equity securities.

**We do not expect to pay dividends.**

We have never paid any cash dividends on our common stock, and we do not anticipate paying any cash dividends in the foreseeable future. We currently intend to retain any future earnings for funding growth and therefore, do not expect to pay any dividends on our common stock in the foreseeable future. Therefore, you may not receive any return on an investment in our common stock in the form of dividends.

**Provisions of our corporate charter documents could delay or prevent a change of control.**

Our Certificate of Incorporation grants our board of directors the authority to determine the relative rights and preferences of our preferred stock and gives the board the authority to issue such shares, all without further stockholder approval. As a result, our board of directors could authorize the issuance of a series of preferred stock that would grant to holders preferred rights to our company's assets upon liquidation, the right to special voting privileges, the right to receive dividends before dividends would be declared upon the common stock and the right to redemption of such

shares, together with a premium, prior to the redemption of common stock. Our common stockholders have no redemption rights. The ability of the board to issue large blocks of preferred stock could have a potential anti-takeover effect, and the issuance of preferred stock in accordance with such authority may delay or prevent a change of control of our company.

## **RISKS RELATED TO OUR INDUSTRY**

**The selling prices for our products are very volatile and subject to industry-wide fluctuations. Our success is dependent on the growth and strength of the PC market and the DVD video market.**

With a focus on the DVD product line, most of our revenues in the last three years were generated from DVD products. Most of our new products currently being developed are in the DVD product line, particularly DVD loaders. The sales of our DVD loaders are related to the markets for DVD video discs and DVD video players. If we experience an unforeseen downturn in the markets for DVD video discs and DVD video players or a global over-supply in the production of DVD loaders, our results of operations from our DVD loaders business will be adversely affected. Our business could be harmed by such industry-wide fluctuations in the future.

**The cyclical nature of the semiconductor industry could create fluctuations in our operating results.**

The semiconductor industry has historically been cyclical, characterized by wide fluctuations in product supply and demand. From time to time, there are shortages or over-production of memory or other types of devices. Our business could be harmed by such industry-wide fluctuations in the future because our products incorporate these technologies. When a shortage occurs with one or more key components, it may be difficult for us to produce enough quantities of products to fill customers' orders, and it may require us to pay a higher price for the components in the event of a shortage, adversely affecting our margin and profitability.

**There is seasonality in our business.**

Sales of our products in the computer peripherals market and consumer electronics market are subject to seasonality. Seasonal purchasing patterns generally lead to higher sales occurring in the second half of each calendar year although there may be a sharp decline of sales near the Christmas and New Year's holidays. Sales to China and certain other Asian regions may also decline near the lunar New Year's holidays in January or February.

### **Item 3. Quantitative and Qualitative Disclosure About Market Risk**

#### **Market Risk**

The following discusses our exposure to market risk related to changes in interest rates and foreign currency exchange rates. This discussion contains forward-looking statements that are subject to risks and uncertainties. Actual results could vary materially as a result of a number of factors including those set forth in "Factors That May Affect Future Results."

#### **Interest Rate Risk**

Our exposure to market risk for changes in interest rates relates primarily to our investment portfolio. We do not use derivative financial instruments in our investment portfolio. The primary objective of our investment activities is to preserve principal while maximizing yields without significantly increasing risk. Our investments consist primarily of commercial paper and certificates of deposits. Due to the nature of our investments, we believe that there is no material risk exposure. Cash equivalents and short-term investment are carried at cost, which approximates market value, and investments in marketable debt securities are carried at amortized cost, which approximates market value.

#### **Foreign Currency Risk**

We develop products in the United States, South Korea and China and market our products in North America and the Asia-Pacific region. As a result, our financial results could be affected by factors such as changes in foreign

currency exchange rates or weak economic conditions in foreign markets. As our sales are primarily in U.S. dollars, a strengthening of the dollar could make our products less competitive in foreign markets.

#### **Item 4. Controls and Procedures**

##### **Evaluation of disclosure controls and procedures.**

Our management evaluated, with the participation of our Chief Executive Officer and our Chief Financial Officer, the effectiveness of our disclosure controls and procedures as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on this evaluation, our Chief Executive Officer and our Chief Financial Officer have concluded that our disclosure controls and procedures are effective to ensure that information we are required to disclose in reports that we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms.

##### **Changes in internal controls.**

There was no change in our internal control over financial reporting that occurred during the period covered by this Quarterly Report on Form 10-Q that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## PART II. OTHER INFORMATION

### Item 1. Legal Proceedings

Not applicable.

### Item 2. Changes in Securities

During the quarterly period ended September 30, 2003, the Company issued 1,343,643 shares of its common stock and warrants to purchase approximately 1,474,018 shares of its common stock to certain accredited investors in transactions not involving any public offering. The Company received proceeds of approximately \$1,811,100 from the sale of its common stock and upon the exercise of outstanding warrants issued during this period. The issuances of the securities described above were made in reliance on one or more of the exemptions from registration under the Securities Act, including those provided for by Section 4(2) and Rule 506 thereunder. The purchasers of these securities represented that they had adequate access to information about the Company.

### Item 3. Defaults Upon Senior Securities

Not applicable.

### Item 4. Submission to Matters to a Vote of Security Holders

Not applicable.

### Item 5. Other Information

Not applicable.

### Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

- 31.1 Certification of the President and Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certifications pursuant to U.S.C. Section 1350, adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

(b) Reports on Form 8-K

On August 18, 2003, the Company filed a current report on Form 8-K dated August 18, 2003 with the Securities and Exchange Commission, as amended on August 18, 2003, to furnish a press release to report the Company's results for the six months ended June 30, 2003.

The Company filed no other Reports on Form 8-K during the quarter ended September 30, 2003.

## SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Date: November 14, 2003

DIGITAL VIDEO SYSTEMS, INC.

By: /s/ DOUGLAS T. WATSON

Douglas T. Watson  
Chief Executive Officer  
(Principal Executive Officer)

/s/ ROBERT BAKER

Robert Baker  
Chief Financial Officer  
(Principal Accounting and Financial Officer)

## EXHIBIT INDEX

<u>Exhibit No.</u>	<u>Description</u>
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