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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 March 31, 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)

**1731 Technology Drive, Suite 810  
San Jose, CA 95110**  
(Address of principal executive offices, including zip code)

**(408) 392-0268**  
(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 filer (as defined in Rule 12b-2 of the Exchange Act).  
Yes ☐ No ☒

As of March 31, 2003, there were approximately 6,832,255 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)

	March 31, 2003	December 31, 2002
	(Unaudited)	(Audited)
<b>ASSETS:</b>		
<b>Current assets:</b>		
Cash and cash equivalents.....	\$ 10,360	\$ 12,330
Restricted cash .....	6,652	5,908
Accounts receivable, net .....	12,767	10,749
Inventories .....	21,711	25,758
Marketable debt securities.....	405	427
Prepaid expenses and other current assets.....	3,513	3,402
Notes receivable – related party .....	884	884
<b>Total current assets .....</b>	<b>56,292</b>	<b>59,458</b>
Property and equipment, net .....	11,465	11,067
Intangibles .....	524	587
Other assets.....	351	315
<b>Total assets .....</b>	<b><u>\$ 68,632</u></b>	<b><u>\$ 71,427</u></b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY:</b>		
<b>Current Liabilities:</b>		
Line of credit.....	\$ 23,478	\$ 26,086
Current portion of long term debt .....	182	192
Accounts payable .....	16,851	13,592
Accounts payable – related party .....	515	434
Accrued liabilities .....	2,254	3,325
Notes payable.....	4,965	4,223
Other payable.....	229	234
<b>Total current liabilities .....</b>	<b>48,474</b>	<b>48,086</b>
<b>Long term liabilities:</b>		
Long term liabilities – long term debt .....	46	96
<b>Total liabilities .....</b>	<b>48,520</b>	<b>48,182</b>
Minority interest .....	11,906	13,434
<b>Stockholders' equity:</b>		
Preferred Stock.....	—	—
Common Stock.....	1	1
Additional paid-in capital.....	74,399	73,334
Cumulative accumulated other Comprehensive Loss.....	771	1,457
Deferred compensation .....	(15)	(20)
Accumulated deficit .....	(66,950)	(64,961)
<b>Total stockholders' equity .....</b>	<b>8,206</b>	<b>9,811</b>
<b>Total liabilities and stockholders' equity .....</b>	<b><u>\$ 68,632</u></b>	<b><u>\$ 71,427</u></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)**

	<b>Three Months Ended March 31,</b>	
	<b>2003</b>	<b>2002</b>
<b>Net revenue</b>	<b>\$ 27,682</b>	<b>\$ 22,867</b>
Cost of revenue .....	<u>27,060</u>	<u>22,734</u>
Gross margin .....	622	133
<b>Operating expenses:</b>		
Research and development .....	1,313	903
Sales and marketing .....	800	633
General and administrative .....	<u>2,024</u>	<u>1,746</u>
<b>Total operating expenses</b> .....	<b><u>4,137</u></b>	<b><u>3,282</u></b>
<b>Loss from operations</b> .....	<b><u>(3,515)</u></b>	<b><u>(3,149)</u></b>
Interest expense .....	(252)	(476)
Other income / (expense) .....	<u>899</u>	<u>(529)</u>
Loss before minority interest and income taxes .....	(2,868)	(4,154)
Income tax provision .....	—	—
Minority interest .....	<u>879</u>	<u>641</u>
<b>Net loss</b> .....	<b><u>\$ (1,989)</u></b>	<b><u>\$ (3,513)</u></b>
Basic net loss per share .....	<u>\$ (0.31)</u>	<u>\$ (0.60)</u>
Diluted net loss per share .....	<u>\$ (0.31)</u>	<u>\$ (0.60)</u>

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

**Digital Video Systems, Inc.**

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

	<b>Three Months Ended March 31,</b>	
	<b>2003</b>	<b>2002</b>
<b>Cash flows from operating activities:</b>		
Net loss .....	\$ (1,989)	\$ (3,513)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Minority interest .....	(879)	(641)
Depreciation and amortization .....	390	545
Issuance of common stock for service provided .....	—	200
Write down of notes receivable .....	—	917
Amortization of deferred compensation .....	5	—
<b>Changes in operating assets and liabilities:</b>		
Accounts receivable .....	(2,018)	(1,712)
Inventories .....	4,047	3,310
Prepaid expenses and other current assets .....	(111)	(1,022)
Other assets .....	10	—
Deferred tax asset .....	(46)	(168)
Accounts payable .....	3,469	2,328
Accrued liabilities .....	(272)	(784)
Other payable .....	76	310
<b>Net cash provided by (used in) operating activities .....</b>	<b><u>2,682</u></b>	<b><u>(230)</u></b>
<b>Cash flows from investing activities:</b>		
Acquisition of property and equipment .....	(725)	(181)
Maturities (purchase) of marketable debt securities .....	22	8
Increase in restricted cash .....	(744)	(350)
<b>Net cash used in investing activities .....</b>	<b><u>(1,447)</u></b>	<b><u>(523)</u></b>
<b>Cash flows from financing activities:</b>		
Proceeds from the sale of common shares .....	56	—
Repayment of line of credit .....	(2,608)	—
Proceeds from notes payable .....	742	1,698
Proceeds from line of credit borrowings .....	—	4,245
Repayment of notes payable .....	(60)	(47)
<b>Net cash (used in) provided by financing activities .....</b>	<b><u>(1,870)</u></b>	<b><u>5,896</u></b>
Effect of exchange rate changes .....	(1,335)	(317)
Net (decrease) increase in cash and cash equivalents .....	(1,970)	4,826
<b>Cash and cash equivalents at beginning of period .....</b>	<b><u>12,330</u></b>	<b><u>10,145</u></b>
<b>Cash and cash equivalents at end of period .....</b>	<b><u>\$ 10,360</u></b>	<b><u>\$ 14,971</u></b>
<b>Supplemental disclosures:</b>		
Interest paid .....	—	51
Taxes paid .....	28	87
<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 .....	799	—

**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 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 period ended March 31, 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. Accounting Changes**

In June 2002, the Financial Accounting Standards Board issued No. 146, "Accounting for Costs Associated with Exit or Disposal Activities." SFAS No. 146 addresses the timing and amount of costs recognized as a result of restructuring and similar activities. The Company will apply SFAS No. 146 to activities initiated after December 31, 2002. The adoption of SFAS No. 146 is not expected to have a material impact on the Company's consolidated statements of income or financial position.

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 is effective for fiscal years ending after December 15, 2002 and have been incorporated into these financial statements and accompanying footnotes.

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.

The Company does not believe that any of these recent accounting pronouncements will have a material impact on their financial position or results of operations.

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

	<b>Three Months Ended March 31,</b>	
	<b>2003</b>	<b>2002</b>
Net loss .....	\$ (1,989)	\$ (3,513)
Weighted average common shares outstanding .....	6,487	5,869
Dilutive stock options and warrants .....	0	0
Total fully diluted shares .....	6,487	5,869
Basic net loss per share .....	\$ (0.31)	\$ (0.60)
Diluted net loss per share .....	\$ (0.31)	\$ (0.60)

### 4. Comprehensive Income (Loss)

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

	<b>Three Months Ended March 31,</b>	
	<b>2003</b>	<b>2002</b>
Net loss .....	\$ (1,989)	\$ (3,513)
Cumulative foreign currency translation adjustments .....	(686)	43
Comprehensive loss .....	\$ (2,675)	\$ (3,470)

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

### 5. Inventories

Inventories consisted of the following (in thousands)

	<b>March 31, 2003</b>	<b>December 31, 2002</b>
Inventories:		
Raw materials .....	\$ 9,059	\$ 9,718
Work-in-process .....	6,770	8,220
Finished goods .....	6,222	8,230
Total inventory .....	22,051	26,168
Less inventory reserves .....	(340)	(410)
Net inventory .....	\$ 21,711	\$ 25,758

### 6. 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.

	<b>Three Months Ended March 31, 2003 (in thousands)</b>
Product line:	
DVD products .....	\$ 27,524
Computer peripherals .....	158
Equipment & materials .....	<u>          </u>
Total sales .....	<u>\$ 27,682</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 months ended March 31, 2003 are as follows (in thousands):

	<b>Three Months Ended March 31, 2003</b>
Geographic:	
Domestic .....	\$ 158
Other international countries .....	<u>27,524</u>
Total sales .....	<u>\$ 27,682</u>

During the three months ended March 31, 2003, the Company had two customers which individually accounted for over 10% of sales. The largest customer accounted for sales of approximately \$7.0 million or approximately 25% of revenue, and the next largest customer accounted for sales of approximately \$4.8 million or approximately 17% of revenue.

## **7. Note Receivable-Related Party**

On September 30, 1999, the Company entered into an Asset Purchase and Option Agreement (the "Agreement") with OPLI, a related party. Pursuant to the Agreement, the Company sold the assets used in its digital video business, which are comprised of the ad insertion business and the video on demand businesses (the "Purchased Assets") to OPLI.

The purchase prices for the Purchased Assets and for the Option (described below) was \$3,450 with the purchased asset valued at \$2,700 and the Option at \$750. The purchase price was paid by delivery of a promissory note in the principal amount of \$3,450 (the "Note"). Principal on the Note is payable in 36 equal monthly installments commencing on October 31, 1999. The unpaid principal balance of the Note bears interest at an annual rate of 7%. The Note was originally secured by a first priority security interest in favor of the Company in the Purchased Assets and a first priority pledge in favor of the Company of 987,500 shares of common stock of the Company owned by OPLI.

Pursuant to the terms of the Agreement, OPLI purchased the option (the "Option") to acquire 212,000 shares (the "Option Shares") of the common stock of DVS Korea Ltd., a corporation organized under the laws of the Republic of Korea and a wholly owned subsidiary of the Company (DVS Korea). The Option Shares constitute 20% of the issued and outstanding shares of capital stock of DVS Korea. The Option was exercisable in whole or in part, for an aggregate exercise price of \$500 payable in cash upon exercise of the Option.

The sale of the Purchased Assets and the Option was recorded as a note receivable. The purchased assets were written off the books as of March 31, 1999 as part of a restructuring. As a result, no book value for these assets exists as of the date of the transaction. The gain of \$2,700 for the sale of the purchased assets has been recognized as other income in the fiscal year ending March 31, 2000.

OPLI exercised its right to acquire the Option Shares in November 1999. The book value of the Option Shares at that time was \$762. The sale of the Option for \$750 and the proceeds of \$500 for exercising the Option resulted in a gain for the sale of the Option Shares. This gain has been recognized as other income in the fiscal year ending March 31, 2000.



At December 31, 2001, the OPLI note receivable outstanding was at \$1,974 and was in default. Payment in arrears totaled \$1.0 million. The shares of the Company's common stock purchased in 1998 plus the assets acquired, giving rise to the note receivable, have been pledged and secured. Some shares of common stock of OPLI shareholders pledged are in the possession of the Company and at December 31, 2001 had a market value that equals approximately the outstanding balance due on the note receivable.

DVS provided OPLI with Notice of Default on October 2, 2002. OPLI failed to cure its default under the note within 10 days of the Notice. On October 17, 2002, the Company gave notice to OPLI declaring all amounts due under the promissory note. At this time, the Company is considering further legal action against OPLI and its shareholders to recover all remaining claims including all legal costs incurred.

During May 2003, the market value of common stock of OPLI shareholders held by the Company was \$0.9 million resulting in an adjustment to the reserve requirement of \$1.1 million. The total reserve at March 31, 2003 is \$1.1 million.

## 8. Other

A foreign investment income tax credit is available to offset 75% 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):

	March 31, 2003	December 31, 2002
Good will .....	\$ —	\$ —
Intangible assets of acquired businesses .....	2,400	2,400
Total intangible assets.....	2,400	2,400
Less: accumulated amortization.....	(1,876)	(1,813)
	<u>\$ 524</u>	<u>\$ 587</u>

In June 2001, the FASB issued SFAS No. 142, *Goodwill and Other Intangible Assets*. Under SFAS No. 142, goodwill and intangible assets with an indefinite life are not amortized. Instead of amortizing goodwill and intangible assets deemed to have an indefinite life, the statement requires a test for impairment to be performed annually, or immediately if conditions indicate that such an impairment could exist. The amortization period of intangible assets with finite lives will no longer be limited to forty years. This statement had the effect of reducing to zero the Company's amortization of goodwill effective January 1, 2002.

## 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 ended March 31, 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 gross margins, 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, conducting business in foreign countries, such as China and South Korea, 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, 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

In the quarter ended March 31, 2003, the Company maintained its market share of the DVD external loader market through its focus on core products developed from its DVD intellectual property portfolio. As reflected in the table below, the Company increased its sales revenues, gross profit, and rate of gross margin in the quarter ended March 31, 2003 as compared to the same quarter a year ago. During the three month period ended March 31, 2003, the loader market experienced severe pricing pressure resulting in average unit sell prices declining approximately 18% in this period. Unit shipments of assembled DVD loaders, however, increased over 50% from the previous quarter. Gross margin of 2.2% for the current quarter, compared favorably to 0.6% for the same period in the prior year.

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

	Three Months Ended March 31,	
	2003	2002
Revenue .....	\$ 27,682	\$ 22,867
Gross profit .....	622	133
Loss from operations .....	(3,515)	(3,149)
Net loss .....	(1,989)	(3,513)

Revenue for the quarter ended March 31, 2003 increased to \$27.7 million, an increase of approximately 21% from \$22.9 million recorded for the quarter ended March 31, 2002. As a primary factor, increased unit sales of 50% and coupled with, to a lesser extent, component sales not present in the prior period more than offset unit price erosion of about 18%. Gross profit was \$0.6 million for the quarter ended March 31, 2003, as compared with \$0.1 million in the same quarter last year due to cost reductions that ran slightly over 20% from quarter to quarter. Loss from operations for the quarter ended March 31, 2003 was \$3.5 million, compared with loss of \$3.1 million in the same quarter of the previous year. The increased gross margin of \$0.5 million was offset by a corresponding increase in operating expenses. Net loss in the quarter ending March 31, 2003 was \$2.0 million as compared to a loss of \$3.5 in the quarter ending March 31, 2002. During the quarter ending March 31, 2002, the Company recorded a write down of note receivable-related party of \$0.9 million and incurred interest expenses prior to the Korean subsidiary's successful public offering in September 2002.

Working capital at March 31, 2003 was \$7.8 million, a decrease of \$3.6 million from \$11.4 million at December 31, 2002. Our Korean subsidiary (DVSK) raised approximately \$10.7 million during the last year and coupled with its line of credit is expected to be able to fund new product programs and support the existing loader business in both Korea and China in the year 2003. The Company plans to meet its operating obligations for 2003 by raising money through private placements and receiving management fees from its Korean subsidiary.

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 March 31, 2003 compared with the three month period ended March 31, 2002. See Consolidated Statements of Operations and related notes thereto for additional details.

Percent of Revenue	Three Months Ended March 31,	
	2003	2002
Revenue .....	100.0%	100.0%
Gross margin.....	2.2%	0.6%
Research and development .....	4.7%	3.9%
Sales and marketing .....	2.9%	2.8%
General and administration .....	7.3%	7.6%
Loss from operations .....	(12.7)%	(13.8)%
Net loss .....	(7.2)%	(15.4)%

Consolidated Revenue	Three Months Ended March 31,		% Change
	2003	2002	
Amount (in thousands).....	\$ 27,682	\$ 22,867	21%

Total revenue increased by \$4.8 million, or 21%, for the three months ended March 31, 2003 as compared with the three months ended March 31, 2002. International revenue, consisting primarily of sales of DVD loaders or CKD (Completely Knocked Down) kits of DVD loaders, represented over 90% of revenue for the quarter ended March 31, 2003. The DVD loaders are sold directly to DVD player manufacturers in China and certain other countries, for export or local consumption. As the majority of such DVD player manufacturers are located overseas, the Company expects that international sales will continue to constitute a significant portion of its revenue for the foreseeable future.

In the three months ended March 31, 2003, foreign sales in China were approximately \$7.0 million or 25% of revenue as compared with \$9.2 million or 40% of revenue for the three months ended March 31, 2002. During this same period Vestel and Daewoo both individually accounted for more than 10% of the Company's sales. No sales were made to our joint venture partner in China.

Gross Profit	Three Months Ended March 31,		% Change
	2003	2002	
Amount (in thousands).....	\$ 622	\$ 133	367%
As a percentage of revenue .....	2.2%	0.6%	—

During the three months ended March 31, 2003, gross margin was \$0.6 million or 2.2% of revenue, as compared to \$0.1 million or 0.6% for the three months ended March 31, 2002. Our costs of goods sold, which consist of purchased components representing about 90% of the loader cost, have been reduced by about 20% in the past year. Purchasing volume and lower costs of assembly in our China joint venture have allowed us to maintain margins during this period of rapid sales price declines. During the near term we believe gross margins will fluctuate between approximately 2% and 5%, depending on the products sold in the period. This unit price erosion and resulting reduction of gross margins is likely to continue during 2003. We are at a point where new products must be introduced if we are to experience any improvement in our rate of gross margin. The amount of engineering effort required to value engineer the loader product during the year 2002 has interrupted the new product programs of our Korean subsidiary, thereby causing delays in the introduction of new products such as DVD players for the automotive market and rewritable DVD drives for the computing and audio markets. The new product engineering group in South Korea is currently working extended hours to get back on schedule, and we believe that the introduction of these two products will occur late in the third quarter of this year. Working prototypes of both these products were shown at the Korean subsidiary's annual meeting in March 2003. Our development efforts are ongoing and we expect to continue product development in future periods. We are not able to predict the level of sales for these new products, if and when they are introduced, or their impact on our gross margins with any degree of certainty for the year 2003.

Research and Development	Three Months Ended March 31,		% Change
	2003	2002	
Amount (in thousands).....	\$ 1,313	\$ 903	45%
As a percentage of revenue .....	4.7%	3.9%	—

Research and development expenses consist primarily of personnel and equipment prototype costs required for the Company's product development efforts. Research and development spending in this quarter increased to 4.7% of revenue, compared with 3.9% for the corresponding quarter a year ago. Additional new product activity has been initiated both in South Korea and in the United States with the formation of MobileTouch Korea and MobileTouch USA, a wholly owned subsidiary of DVS Korea and the Company, respectively. The subsidiaries working in partnership with Jeecom, Inc. will develop new products and applications directed at the corporate and consumer mobile applications market, and in particular will focus on media rich applications for the consumer market. MobileTouch USA has begun the development of software required to optimize the utilization of new MPEG-4 part 10 video compression in mobile wireless products and software in support of the decoder chip also being developed by MobileTouch USA. MPEG-4 part 10 is an industry standard used in the development of products based on digital formats. Industry representatives have organized committees and review boards to define certain international compression standards for storage and playback of digital audio and video data. DVS must continue to anticipate and monitor the development of new industry standards, such as MPEG-4 part 10, in order to introduce new products and remain competitive in the consumer electronics industry. We believe that this new standard offers substantial benefits to many potential product areas such as, low bandwidth video for mobile handsets, DVD video, broadband entertainment, and digital cinema. As of March 31, 2003, we are continuing our development efforts with respect to these technologies. We do not expect any major sales activity from these developments in the year 2003.

In January 2003, the Company announced an exclusive licensing agreement with Jeecom, Inc., a company founded by, and whose majority owner is, Dr. Edmund Sun, the Company's Chief Technology Officer. We expect the Jeecom, Inc. license and software to provide the platform for integrating video and other multimedia products for the mobile market with the exclusive right to market the software to the major markets of the world. The license agreement provides DVS with a worldwide license with an initial term tied to the duration of the copyright for the software developed thereunder. The agreement is renewable for a term based on the duration of any patent issued with respect to any technology developed under the agreement. DVS will pay Jeecom a development fee of \$250,000 and royalties ranging from \$2 to \$10 per unit for products developed under the agreement and based on the number of units sold.

As noted above, we have sought to diversify our product base through increased emphasis on new products such as the rewritable drive which we anticipate will enjoy much greater margins and, more importantly, will sell into the larger market and customer base that DVSK has successfully established with our DVD loader products. However, in merging these vital areas of development in 2003, we expect research and development expenses to continue to increase as a percentage of revenue and to generate losses as we invest heavily in R&D personnel and engineers.

<b>Sales and Marketing</b>	<b>Three Months Ended March 31,</b>		<b>% Change</b>
	<b>2003</b>	<b>2002</b>	
Amount (in thousands).....	\$ 800	\$ 633	26%
As a percentage of revenue.....	2.9%	2.8%	—

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 March 31, 2003 increased in dollar terms by \$0.2 million, or 26%, as compared with the corresponding quarter of 2002. As a percentage of revenue sales and marketing expenses remained essentially unchanged from the three month period ended March 31, 2002 to the three month period ended March 31, 2003. The increase in dollar terms resulted from additional sales and marketing activities necessary to generate the increased revenue.

<b>General and Administrative</b>	<b>Three Months Ended March 31,</b>		<b>% Change</b>
	<b>2003</b>	<b>2002</b>	
Amount (in thousands).....	\$ 2,024	\$ 1,746	16%
As a percentage of revenue.....	7.3%	7.6%	—

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 March 31, 2003 increased by \$0.2 million compared to the corresponding quarter in 2002.

This increase was due to the additional administrative activities associated with the increase in revenue and establishment of production facilities in South Korea and the Joint Venture in China.

## Liquidity and Capital Resources

While the Company had cash and equivalents of nearly \$17 million at March 31, 2003, working capital at March 31, 2003 had declined \$3.6 million to \$7.8 million as compared with working capital of \$11.4 million at December 31, 2002. We believe it will be necessary for us to raise additional funds through the sale of debt or equity securities in either the U.S. or South Korea, in order to meet our objectives for worldwide operations for the year 2003.

Net cash provided by operating activities was \$2.7 million for the three months ended March 31, 2003 as compared with \$0.2 million used in operating activities in the three months ended March 31, 2002. Cash was provided as inventories declined by \$4.0 million, with an increase in accounts payable of \$3.5 million, and non-cash charges for depreciation and amortization of \$0.4 million. The use of cash by operating activities was caused by net losses of \$2.0 million, increased accounts receivable of \$2.0 million, with a decrease in accrued liabilities of \$0.3 million, and minority interest expense of \$0.9 million.

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

	<b>Twelve Months Ended March 31, 2003</b>
Inventory turn .....	9.9 X
Receivable turn .....	19.5 X

We currently expect that for the year 2003, inventories will turn at a slightly lower rate than in the previous twelve-month period. Receivable turns, however, in the year 2003 will be significantly lower than in the previous twelve-month period due to the competitive market, which would require the Company to extend open credit terms to maintain and attract customers. Currently, in the quarter ending March 31, 2003, the receivable turn was approximately 9.4X, or 38.8 days.

Net cash used in investing activities was \$1.4 million for the three months ended March 31, 2003, primarily consisting of the increase in restricted cash by 0.7 million and \$0.7 million for acquisition of property and equipment.

Net cash used in financing activities was \$1.9 million for the three months ended March 31, 2003 as compared to \$5.9 million provided during the three months ended March 31, 2002. The cash used in financing activities in this period primarily was \$2.6 million for repayment of line of credit. The cash provided by financing activities in this period consisting of \$0.7 million in net proceeds from notes payable.

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.

We believe that with working capital of \$8.2 million at March 31, 2003, and the renewal of our existing lines of credit in South Korea, now totaling \$63 million of which we have taken down \$23.5 million, that our operations in Asia have sufficient resources to manage both their new product plans and production requirements for the year 2003. We expect that our operations in the U.S. will require the raising of additional capital to finance MobileTouch USA. The Company is currently in discussions with investment firms and hopes to have agreements reached for this funding in the near future. However, our current and future capital requirements are substantial and we cannot be certain that financing will be available at favorable terms when required, or at all.

## 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.**

Our recent growth rate may not be sustainable and you should not use our past financial performance to predict future operating results. In addition to the losses incurred 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;
- 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. Although our relationship with our key suppliers are material in the aggregate, we do not have any one specific agreement with any particular supplier that is material to our business. Any constraints on worldwide manufacturing capacity of these key components may affect our ability to obtain adequate supplies from these manufacturers. 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 99.4% 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 quarter ended March 31, 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 recently 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 61% of our revenues during the year ended December 31, 2002 and quarter ended March 31, 2003, respectively. Products sold to our top 10 customers accounted for approximately 75%, 88%, 67%, and 80% 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 quarter ended March 31, 2003, respectively. In the quarter ended March 31, 2003, Vestel accounted for 25% of our revenue. 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 \$63 million as of March 31, 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, and at the time and place that we need them. 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 Disclosures 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 approximated 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 chief executive officer and our chief financial officer, after evaluating our "disclosure controls and procedures" (as defined in Securities Exchange Act of 1934 (the "Exchange Act") Rules 13a-14 (c) and 15-d as of a date (the "Evaluation date") within 90 days before the filing date of this Quarterly Report on Form 10-Q have concluded that as of the Evaluation Date, 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 Exchange Act is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms.

**Changes in internal controls.**

Subsequent to the Evaluation Date, there were no significant changes in our internal controls or in other factors that could significantly affect our disclosure controls and procedures, nor were there any significant deficiencies or material weaknesses in our internal controls. As a result, no corrective actions were required or undertaken.

## **PART II. OTHER INFORMATION**

### **Item 1. Legal Proceedings**

We may from time to time become a party to various legal proceedings arising in the ordinary course of our business. We do not believe that the outcome of any of such legal matters arising in the ordinary course of business will have a material adverse effect on our business, operating results or financial condition.

On June 18, 2001, the Company filed a lawsuit in the Santa Clara County Superior Court against Ernst & Young, LLP, the Company's former auditors. The complaint includes claims of professional negligence, breach of contract, breach of fiduciary duty, fraud and deceit. The parties participated in mediation proceedings in April 2003 and are currently negotiating terms of settlement.

On June 24, 2002, the Company filed a lawsuit in the Santa Clara County Superior Court against Mali Kuo, Michael Chen, Meng Tek Ung and Doe's 1 through 50, alleging breach of fiduciary duty and seeking declaratory relief, cancellation and rescission of certain written agreements, damages, costs and attorneys' fees. Of the named defendants, Ms. Kuo and Mr. Chen, were both directors and executive officers of the Company for periods between 1999 and 2002, and Mr. Ung was an executive officer of the Company from 1999 to 2002. The complaint alleges that Ms. Kuo breached her fiduciary duties of care and loyalty when she defrauded the Company and misappropriated Company property with the purpose of furthering the private interests of all defendants. The complaint has been served on Mr. Chen and Ms. Kuo, but the Company has not yet been able to serve the other named or unnamed defendants as they reside outside of the United States. The Company believes it will obtain a favorable outcome to the suit. As of March 31, 2003, the Company has received Mr. Chen and Ms. Kuo's counter claim with respect to alleged unpaid wages and expenses. The Company has established an accrual of \$650,000 for wages and expenses related to prior employment of Mr. Chen and Ms. Kuo which the Company believes is adequate.

DVS has been named as a defendant in several other lawsuits in the normal course of its business. In the opinion of management, after consulting with legal counsel, the liabilities, if any, resulting from these matters will not have a material effect on the consolidated financial statements of the Company.

While we have accrued certain amounts for the estimated legal costs associated with defending these matters, there can be no assurance that these cases and other third party assertions will be resolved without costly litigation, in a manner that is not adverse to our financial position, results of operations or cash flows or without requiring royalty payments in the future which may adversely impact gross margins. No estimate can be made of the possible loss or possible range of loss associated with the resolution of these contingencies.

### **Item 2. Changes in Securities and Use of Proceeds**

During fiscal quarter ended March 31, 2003, the Company issued an aggregate of 648,700 shares of DVS common stock and warrants to purchase an aggregate of 225,000 shares of DVS common stock at an exercise price of \$1.00 per share to certain creditors of DVS in exchange for cancellation of indebtedness of approximately \$1,497,372. 120,000 of the shares were issued pursuant to the exercise of outstanding warrants at an exercise price of \$1.50 per share. The proceeds from the exercise of the warrants totaled \$180,000 and will be used for general corporate purposes, including working capital and capital expenditures. The Company relied upon Section 4(2) of the Securities Act of 1933, as amended, as the basis for exemption from registration for the issuance of the shares and warrants. The transaction in which the shares and warrants were issued did not involve any public offering.

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

- (a) Exhibits
  - 10.1 Lease agreement for Shanghai facility.
  - 99.1 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

None.

## SIGNATURE

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: May 15, 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)

## CERTIFICATION

I, Douglas T. Watson, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Digital Video Systems, Inc.;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:
  - a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
  - b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and
  - c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
  - a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
  - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

May 15, 2003

By: /s/ DOUGLAS T. WATSON

Name: Douglas T. Watson

Title: President and Chief Executive Officer

## CERTIFICATION

I, Robert Baker, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Digital Video Systems, Inc.;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:
  - a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
  - b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and
  - c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
  - a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
  - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

May 15, 2003

By: /s/ ROBERT BAKER

Name: Robert Baker

Title: Chief Financial Officer

## EXHIBIT INDEX

<b>Exhibit No.</b>	<b>Description</b>
10.1*	Lease agreement for Shanghai facility.
99.1	Certifications pursuant to U.S.C. Section 1350, adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

\* To be filed by amendment