SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2004

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	**77-0333728**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)

430 Cambridge Avenue, Suite 110
Palo Alto, California 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 [X] NO [ ]

Indicate by check mark whether the registrant is an accelerated filed (as defined in Rule 12b-2 of the Exchange Act). YES [ ] NO [X]

As of March 31, 2004, there were approximately 10,160,317 shares of the registrant's common stock outstanding.

DIGITAL VIDEO SYSTEMS, INC.
Form 10-Q
Index

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

Digital Video Systems, Inc.
Condensed Consolidated Balance Sheets
(In Thousands)
(Unaudited)

	March 31, 2004	December 31, 2003
ASSETS		
Current assets:		
Cash and cash equivalents	$ 3,038	$ 6,444
Restricted cash	5,745	6,186
Marketable debt securities	660	423
Accounts receivable, net	4,577	2,045
Accounts receivable – related party	2,921	3,176
Inventories, net	19,374	24,645
Prepaid expenses and other current assets	2,242	2,081
Note receivable – related party	732	732
Total current assets	39,289	45,732
Property and equipment, net	12,580	12,639
Intangibles	272	335
Other assets	421	65
Total assets	$ 52,562	$ 58,771
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Line of credit	$ 23,243	$ 26,051
Notes payable	4,799	3,603
Notes payable – related party	—	60
Accounts payable	8,835	11,903
Accounts payable – related party	—	524
Other payables	3,006	626
Accrued liabilities	2,069	1,953
Total current liabilities	41,952	44,720
Minority interest	6,863	8,186
Stockholders' equity		
Preferred stock, $0.0001 par value, 5,000,000 shares authorized; no shares issued and outstanding	—	—
Common stock, $0.0001 par value, 30,000,000 shares authorized; 10,160,317 and 8,881,090 shares issued and outstanding, respectively	1	1
Additional paid-in capital	79,838	77,650
Deferred compensation	—	(1)
Accumulated other comprehensive loss	1,902	1,521
Accumulated deficit	(77,994)	(73,306)
Total stockholders' equity	3,747	5,865
Total liabilities and stockholders' equity	$ 52,562	$ 58,771

The accompanying notes are an integral part of these condensed consolidated financial statements.

Digital Video Systems, Inc.
Condensed Consolidated Statements of Operations
(In Thousands, except Per Share Amounts)
(Unaudited)

	Three Months Ended March 31,	
	2004	2003
Net revenue	$ 17,522	$ 27,682
Cost of revenue	18,514	27,060
Gross profit	(992)	622
Operating expenses:		
Research and development	1,745	1,313
Sales and marketing	931	800
General and administrative	2,325	2,024
Total operating expenses	5,001	4,137
Loss from operations	(5,993)	(3,515)
Interest expense, net	(317)	(252)
Other income (expense), net	(61)	899
Loss before minority interest and income taxes	(6,371)	(2,868)
Minority interest	1,683	879
Net loss	$ (4,688)	$ (1,989)
Basic and diluted net loss per share	$ (0.49)	$ (0.31)
Weighted average common shares and equivalent outstanding	9,624	6,391

The accompanying notes are an integral part of these condensed consolidated financial statements.

Digital Video Systems, Inc.
Condensed Consolidated Statements of Cash Flows
(In Thousands)
(Unaudited)

	Three Months Ended March 31, 2004	Three Months Ended March 31, 2003
Cash flows from operating activities:		
Net loss	$ (4,688)	$ (1,989)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Minority interest	(1,683)	(879)
Depreciation and amortization	1,007	390
Issuance of stock and warrants for service provided	129	—
Amortization of deferred compensation	1	5
Changes in operating assets and liabilities:		
Accounts receivable	(2,277)	(2,018)
Inventories	5,271	4,047
Prepaid expenses and other current assets	(161)	(111)
Other assets	(356)	10
Deferred tax asset	—	(46)
Accounts payable	(3,592)	3,469
Accrued liabilities	116	(272)
Other payable	2,380	76
Net cash provided by (used in) operating activities	(3,853)	2,682
Cash flows from investing activities:		
Acquisition of property and equipment	(885)	(725)
(Purchases) maturities of marketable debt securities	(237)	22
Decrease (increase) in restricted cash	441	(744)
Net cash used in investing activities	(681)	(1,447)
Cash flows from financing activities:		
Proceeds from the sale of common shares, net	2,002	56
Proceed from the exercise of options and warrants	57	—
Repayment of line of credit	(2,808)	(2,608)
Proceeds from notes payable	3,000	742
Repayment of notes payable	(1,864)	(60)
Net cash provided by (used in) financing activities	387	(1,870)
Effect of exchange rate changes	741	(1,335)
Net decrease in cash and cash equivalents	(3,406)	(1,970)
Cash and cash equivalents at beginning of period	6,444	12,330
Cash and cash equivalents at end of period	$ 3,038	$ 10,360

The accompanying notes are an integral part of these 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 consolidated financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2003.

In the opinion of the management, the accompanying unaudited condensed consolidated financial statements have been prepared on the same basis as the audited consolidated 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, 2004 are not necessarily indicative of the results that may be expected for any other interim period or the full fiscal year ending December 31, 2004. 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 January 2003, the Financial Accounting Standard Board (“FASB”) issued Interpretation No. 46 (“FIN 46”), “Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51”. FIN 46 requires certain variable interest entities to be consolidated by the primary beneficiary of the entity if the equity investors in the entity do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. FIN 46 is effective immediately for all new variable interest entities created or acquired after January 31, 2003. For variable interest entities created or acquired prior to February 1, 2003, the provisions of FIN 46 have been delayed and currently apply to the first fiscal year or interim period beginning after December 15, 2003. We do not have any entities as of March 31, 2004 that will require disclosure or new consolidation as a result of adopting the provisions of FIN 46.

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 loss and net 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	
	March 31, 2004	March 31, 2003
Reported net loss	$ (4,688)	$ (1,989)
Add: Stock-based compensation, as reported	1	5
Deduct: Total stock-based compensation determined under fair value based method for all awards	(126)	(121)
Proforma net loss, fair value method for all stock-based awards	$ (4,813)	$ (2,105)
Basic and diluted loss per share – as reported	$ (0.49)	$ (0.31)
Basic and diluted loss per share – proforma	$ (0.50)	$ (0.31)

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	
	March 31, 2004	March 31, 2003
Weighted average risk-free interest rates	1.81%	2.97%
Average expected life (in years)	3.0	2.0
Volatility	155%	109% - 125%

The weighted average grant date fair value of stock awards granted during the three months ended March 31, 2004 and 2003 was $1.41 and $1.06 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 March 31,	
	2004	2003
Net loss	$ (4,688)	$ (1,989)
Weighted average common shares outstanding (1)	9,874	6,487
Weighted average unvested restricted stock (1)	(250)	(96)
Weighted average common shares outstanding – basic (1)	9,624	6,391
Effect of diluted stock options and warrants	-	-
Weighted average common shares and equivalent outstanding – diluted	9,624	6,391

(1) At March 31, 2004 and 2003, 5,362,280 and 1,395, 019 shares underlying options and warrants, respectfully, were excluded from the calculation of the diluted earnings per share because the effect is anti-dilutive.

5. Comprehensive Loss

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

	Three Months Ended March 31, 2004	2003
Net loss	$ (4,688)	$ (1,989)
Cumulative foreign currency translation adjustments	381	(686)
Comprehensive loss	$ (4,307)	$ (2,675)

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

6. Balance Sheet Components

Inventories consisted of the following (in thousands):

	March 31, 2004	December 31, 2003
Inventories:		
Raw materials	$ 12,887	$ 16,716
Work-in-process	5,102	2,892
Finished goods	2,956	6,124
Total inventory	20,945	25,732
Less inventory reserves	(1,571)	(1,087)
Net inventory	$ 19,374	$ 24,645

Intangible assets consisted of the following (in thousands):

	March 31, 2004	December 31, 2003
Intangible assets of acquired businesses	$ 2,400	$ 2,400
Less: accumulated amortization	(2,128)	(2,065)
	$ 272	$ 335

7. Segment Information

The Company is organized in a single business segment of developing, producing and marketing digital video technology related products which include DVD loaders and other DVD products.

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, 2004 and 2003 are as follows (in thousands):

	Three Months Ended March 31, 2004	2003
Geographic:		
Domestic	$ 449	$ 158
Other international countries	17,073	27,524
Total sales	$ 17,522	$ 27,682

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 three months ended March 31, 2004 (in thousands):

Warranty accrual, beginning of period	$ 54
Additions	—
Subtractions	—
Warranty accrual, end of period	$ 54

9. Concentration of Certain Risks

The Company is subject to the risks associated with similar technology companies. These risks include, but are not limited to: history of operating losses, dependence on a limited number of key individuals, customers and suppliers, competition from larger and more established companies, the impact of rapid technological changes and changes in customer demand and requirements.

Revenues from significant customers, those representing approximately 10% of more of total revenues, are summarized as follows:

	Three Months Ended March 31,	
	2004	2003
Customer A	22%	*
Customer B	18%	*
Customer C	16%	*
Customer D	11%	25%
Customer E	*	17%

(* = less than 10%)

The largest customer, Ellion Digital, Inc., a company in which certain DVSK employees, officers and directors have a significant ownership interest, accounted for approximately 22% of our total revenue. Ellion Digital, Inc. comprised 39% of the combined total of accounts receivable and accounts receivable from related party at March 31, 2004.

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.

10. Common Stock

In January 2004, we sold 1,212,121 shares of our common stock to a group of purchasers for $1.65 per share. The gross proceeds were approximately $2.0 million. The proceeds are being used for general corporate purposes and initial funding of DVS Electronics, Pvt. Ltd., (DVSE), the Company's subsidiary in India which was formed in 2003.

11. Legal Matters

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. The complaint has been served on Mr. Chen and Ms. Kuo but the Company has not yet been able to serve the other named defendants as they are residing outside of the United States. The Company believes it will obtain a favorable outcome to the suit. As of December 31, 2002, the Company has received Mr. Chen and Ms. Kuo's counter claim. The Company has established an accrual of $0.6 million for wages and expenses related to prior employment of Mr. Chen and Ms Kuo.

The Company has been named as a defendant in several other lawsuits in the normal course of its business. Management currently does not believe that the liabilities, if any, resulting from these matters will have a material effect on the consolidated financial statements of the Company.

12. Notes Payable and Line of Credit

During the first quarter, the Company repaid a $1.8 million note payable to the Shanghai Bank. It also obtained two new notes from the Shanghai Bank totaling $3.0 million. These notes bear interest at libor plus 0.75% per annum, and are due in June 2004. The Company also repaid $2.8 million on its credit line with its Korean banks. The total borrowing limit as of March 31, 2004 with these Korean banks was $30.5 million, and as of May 10, 2004 the borrowing limit has been reduced to $28.7 million.

13. Subsequent Events

In April 2004, investors exercised outstanding warrants for 511,862 shares of common stock resulting in net proceeds of approximately $0.6 million. The warrants were originally issued in the July 2003 financing and were temporarily repriced to $1.25 per share from the original exercise price of $2.80 in order to induce the exercise. We intend to use the proceeds from the warrant exercise for general corporate purposes.

In May 2004, our Korean subsidiary signed an agreement for the sale of MobileTouch Co. Ltd., its wholly owned subsidiary, for $0.8 million. Consideration will consist of cash of $0.3 million and a $0.5 million note bearing interest at 10% per annum due in one year. The sale of the subsidiary is contingent upon several factors, including satisfactory completion of due diligence by the purchaser and their ability to obtain satisfactory financing, and the purchase price is subject to adjustment based on stated items. The closing of the sale is intended to occur during the second quarter of 2004.

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, 2003 and the condensed consolidated financial statements and notes thereto included herein for the three months ended March 31, 2004. 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 , revenues and expected losses, 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, the development of the Company's products, expected spending levels for research and development and rates of inventory and receivable turns. 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, difficulties in 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, 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. Fluctuations of the U.S. dollar against foreign currencies and changes in local regulatory or economic conditions, among other things, could adversely affect our operating results.

Results of Operations

Overview

The Company has a 51% ownership interest in a subsidiary in Korea (DVSK) which generates most of our revenues. DVSK has a majority ownership interest in a manufacturing joint venture in China where a significant portion of our production is performed and additional revenues are generated.

In 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. 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, we have continued to supply 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, and constituted approximately 31% of our revenues in the first quarter of 2004. Consequently, due to these factors plus the inventory charge for obsolete and excess inventory, during the quarter ended March 31, 2004, we incurred a negative gross margin.

Accordingly, the Company has focused on developing products for users who will pay a premium for the increased functionality and reliability of our DVD products, such as automotive and read/write DVD products. We anticipate that these new automotive and read/write products have the potential for higher margins and will favorably impact gross margins in future periods. However, for the first quarter of 2004, sales of these new products only accounted for a limited portion of our total revenues.

Working capital has declined from $1.0 million at December 31, 2003 to a $2.7 million deficit at March 31, 2004. Our line of credit in Korea has been reduced to $30.5 million at March 31, 2004, with further reductions anticipated during the second quarter, and our operations in the United States will require additional funding. Consequently, an infusion of equity and/or debt subordinate to our existing bank debt may be required to help fund our operations. There is no assurance that the Company will be able to raise additional capital on acceptable terms or at all.

Results of Operations

The following table summarizes the Company's operating results (in thousands):

	Three Months Ended March 31, 2004	Three Months Ended March 31, 2003
Revenue	$ 17,522	$ 27,682
Gross profit	(992)	622
Loss from operations	(5,993)	(3,515)
Net loss	(4,688)	(1,989)

We anticipate that the introduction of our new automotive and read/write products will result in increased revenues and improved gross margins in future periods. However, limited availability of parts and working capital may limit the growth in revenues. Further, the minority interest in DVSK will limit the earnings that can be realized by the Company when and if DVSK returns to profitability. Consequently, we anticipate that we may continue to incur a net loss equal to or greater than that incurred in the comparable quarter in 2003 for at least the next quarter.

The Three Months Ended March 31, 2004
Compared to the Three Months Ended March 31, 2003

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, 2004 compared with the three month period ended March 31, 2003.

Percent of Revenue	Three Months Ended March 31, 2004	Three Months Ended March 31, 2003
Revenue	100.0%	100.0%
Gross margin	(5.7)%	2.2%
Research and development	10.0%	4.7%
Sales and marketing	5.3%	2.9%
General and administration	13.3%	7.3%
Loss from operations	(34.2)%	(12.7)%
Net loss	(26.8)%	(7.2)%

Consolidated Revenue	Three Months Ended March 31, 2004	Three Months Ended March 31, 2003	% Change
Amount (in thousands)	$ 17,522	$ 27,682	(37)%

Total revenue decreased by $10.2 million, or 37%, for the three months ended March 31, 2004 as compared with the three months ended March 31, 2003. This decrease is primarily attributable to erosion of average selling prices for our products and the shift by many large customers to in-house loader manufacturing requiring only certain lower price components from the Company. In the quarter ended March 31, 2004, Ellion Digital, Inc., a Korean DVD player manufacturer in which certain officers, directors and employees of our Korean subsidiary have a significant ownership interest, Kaixinda, Farimex and Vestel accounted for 22%, 18%, 16% and 11% of our revenue, respectively. In the quarter ended March 31, 2003, Vestel accounted for 25% of our revenue. The revenue generated from Ellion Digital is primarily related to the assembly of complete DVD players, for which we charge the cost of material and an assembly fee. We are inquiring into the relationship between DVSK and Ellion. We have received a preliminary report on this relationship that we are reviewing, but require additional time and information to draw meaningful conclusions.

Gross Profit	Three Months Ended March 31, 2004	2003	% Change
Amount (in thousands)	$ (992)	$ 622	(259)%
As a percentage of revenue	(5.7%)	2.2%	—

The negative gross margin in the first quarter of 2004 is attributable to the decline in the selling prices of DVD loaders and components during these periods due to increased competition. In addition, we recorded a $0.5 million provision during the quarter for obsolete and excess inventories.

Our new products engineering group in South Korea has developed and is developing DVD players for the automotive market and read/write drives that we expect will provide a higher margin contribution in future periods. However, should the prices of our new products experience similar reductions in prices in the near term, our total margins will not improve to the level anticipated and our results of operations and financial position will be harmed significantly.

Research and Development	Three Months Ended March 31, 2004	2003	% Change
Amount (in thousands)	$ 1,745	$ 1,313	33%
As a percentage of revenue	10.0%	4.7%	—

Our research and development expenses consist primarily of salaries and related costs of employees engaged in ongoing research, design and development activities and providing our OEM customers with custom design and value engineering options to meet their specific requirements. R&D spending increased by $0.4 million, or 33%, primarily due to additional engineers and support staff added to accelerate the development of the new product programs for the automotive and DVD read/write markets and to initiate MobileTouch Korea's R&D plan. We expect to continue spending at approximately the same rate in absolute dollar terms during 2004.

Sales and Marketing	Three Months Ended March 31, 2004	2003	% Change
Amount (in thousands)	$ 931	$ 800	16%
As a percentage of revenue	5.3%	2.9%	—

Sales and marketing expenses consist primarily of employee related expenses, export freight and insurance, and advertising/promotional costs. The Company has sales and marketing organizations in Korea, China, India and the United States. The $0.1 million increase in expenses comparing the periods is due to the establishment of our subsidiary in India which incurred $0.3 million of sales and marketing expense in the first quarter of 2004.

General and Administrative	Three Months Ended March 31, 2004	2003	% Change
Amount (in thousands)	$ 2,325	$ 2,024	15%
As a percentage of revenue	13.3%	7.3%	—

General and administrative expenses consist of administrative salaries, bonuses, benefits, insurance, facility, legal, accounting services, investor relations and other business support costs. The increase in expenses of $0.3 million comparing the periods is primarily due to increased legal fees.

Other Income/ (Expense)	Three Months Ended March 31, 2004	2003	% Change
Amount (in thousands)	$ (61)	$ 899	(107%)
As a percentage of revenue	(0.3%)	3.3%	—

Other expense of $0.1 million in the three months ending March 31, 2004 consisted primarily of an exchange loss of $0.3 million offset by $0.2 million of other income. In the three months ended March 31, 2003 other income of $0.9 million consisted primarily of an exchange gain of $0.7 million and interest income of $0.2 million.

Interest expense of $0.3 million in the three months ending March 31, 2004 and March 31, 2003 consisted primarily of costs associated with borrowings outstanding during the quarters ended, respectively.

Liquidity and Capital Resources

At March 31, 2004, the Company had $8.8 million of cash and equivalents, of which $5.7 million was restricted as collateral for lines of credit.

Net cash used in operating activities was $3.9 million during the first quarter of 2004. We experienced a net loss of $4.7 million, adjusted by the non-cash reduction in the minority interest of the investors of our DVSK subsidiary and China joint venture of $1.7 million. Accounts receivable increased by $2.3 million as we issued increased credit terms to our customers due to competitive pressures, and accounts payable decreased by $3.6 million due to the reduction in manufacturing operations as compared to the prior year end. Offsetting these uses of cash was an increase of other payables by $2.4 million, and a decrease in inventories by $5.3 million attributable to a decrease in revenues in the recent quarter ended March 31, 2004, as compared to December 31, 2003, and the non-cash impact of depreciation and amortization of $1.0 million.

Cash provided by operating activities in the first quarter of 2003 was $2.7 million. Cash was provided as inventories declined by $4.0 million, accounts payable increased by $3.5 million and non-cash charges for depreciation and amortization were $0.4 million, partially offset by the net loss of $2.0 million and an increase in accounts receivable of $2.0 million.

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

	Twelve Months Ended March 31,	
	2004	**2003**
Inventory turn	3.5 X	9.9 X
Receivable turn	7.6 X	19.5 X

We currently expect that for the year ended December 31, 2004, our inventories will turn at a higher rate than in the previous twelve-month period. Receivable turns in 2004, however, are likely to be lower than in the previous twelve-month period in the near term due to the competitive market for our DVD loaders, which will likely require the Company to continue to extend open credit terms to maintain and attract customers. The Company is attempting to obtain prepayments on its new products which if successful should improve receivable turns later in the year as sales of these products increase.

Net cash used in investing activities was $0.7 million for the three months ended March 31, 2004, which primarily consisted of the acquisition of $0.9 million of property and equipment and purchases of marketable debt securities of $0.2 million partially offset by a decrease in restricted cash of $0.4 million. Net cash used in investing activities was $1.4 million for the three months ended March 31, 2003, which primarily consisted of an increase in restricted cash of $0.7 million and the acquisition of $0.7 million of property and equipment.

Net cash provided by financing activities was $0.4 million for the three months ended March 31, 2004. The cash provided by financing activities in this period was primarily from the $2.1 million in proceeds from sales of shares of common stock and exercise of options and warrants and the $3.0 million of proceeds from notes payable partially offset by payment on the line of credit and notes payable of $4.7 million. In January 2004, we sold 1,212,121 shares of our common stock to a group of purchasers for $1.65 per share with gross proceeds of approximately $2.0 million. Net cash used in financing activities was $1.9 million for the three months ended March 31, 2003. The cash used in financing activities in this period was primarily repayment of borrowings of $2.6 million by our Korean subsidiary under credit lines, partially offset by $0.7 million in net proceeds from notes payable.

In April 2004, investors exercised outstanding warrants for 511,862 shares of common stock resulting in net proceeds of approximately $0.6 million. The warrants were originally issued in the July 2003 financing and were temporarily repriced to $1.25 per share from the original exercise price of $2.80 in order to induce the exercise. The Company intends to use the proceeds from the warrant exercise for general corporate purposes.

In May 2004, DVSK signed an agreement for the sale of MobileTouch Co. Ltd., its wholly owned subsidiary, for $0.8 million. Consideration will consist of cash of $0.3 million and a $0.5 million note bearing interest at 10% per annum due in one year. The sale of the subsidiary is contingent upon several factors, including satisfactory completion of due diligence by the purchaser and their ability to obtain satisfactory financing, and the purchase price is subject to adjustment based on stated items. The closing of the sale is intended to occur during the second quarter of 2004.

Our working capital deficit is $2.7 million at March 31, 2004, as compared to working capital of $1.0 million at December 31, 2003. Our bank lines in Korea have been reduced as of May 10, 2004 to $28.7 million due to our current operating levels and concern over our losses. We believe that the bank lines will be reduced further during the second quarter of 2004. We are attempting to offset these reductions in our lines of credit by reducing the credit extended to our largest customer. In addition, we are requesting prepayments from our customers on our new products and requesting extended payment terms from our vendors, although there is no assurance that we will be successful in these actions. Consequently, we believe that an infusion of equity and/or debt subordinate to our existing bank debt may be required to help fund our operations. In addition, our operations in the United States will require the raising of additional capital in order to meet currently anticipated requirements. The Company is currently in discussions with investment firms and anticipates raising such funds during the second quarter of 2004. There is no assurance that the Company will be able to raise additional capital on acceptable terms or at all. If we do not raise additional capital, we may not be able to meet our financial obligations, and may have to cease or curtail our operations.

Contractual Obligations

The following table summarizes our significant contractual obligations at March 31, 2004.

	Payments Due by Period (in 000's)				
Contractual Obligations	**Total**	**Less Than 1 Year**	**1-3 Years**	**4-5 Years**	**After 5 Years**
Operating lease obligations	$ 1,501	$ 620	$ 661	$ 31	$ 189
Line of credit	23,243	23,243	-	-	-
Notes payable	4,799	4,799	-	-	-
Total contractual obligations	$ 29,543	$ 28,662	$ 661	$ 31	$ 189

Off-Balance Sheet Arrangements

The Company had no "Off-Balance Sheet Arrangements" (as defined by Item 303 of Regulation S-K) at March 31, 2004.

Recent Accounting Pronouncements

In January 2003, the Financial Accounting Standard Board ("FASB") issued Interpretation No. 46 ("FIN 46"), "Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51". FIN 46 requires certain variable interest entities to be consolidated by the primary beneficiary of the entity if the equity investors in the entity do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. FIN 46 is effective immediately for all new variable interest entities created or acquired after January 31, 2003. For variable interest entities created or acquired prior to February 1, 2003, the provisions of FIN 46 have been delayed and currently apply to the first fiscal year or interim period beginning after December 15, 2003. We do not have any entities as of March 31, 2004 that will require disclosure or new consolidation as a result of adopting the provisions of FIN 46.

Critical Accounting Policies

Management's discussion and analysis of our financial condition and results of operations are based upon our condensed consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses and related disclosures of contingent assets and liabilities. On an ongoing basis, we evaluate our estimates, including those related to product returns, accounts receivable, inventories, investments, intangible assets, income taxes, warranty obligations, restructuring, contingencies and litigation. Actual results may differ from these estimates under different assumptions or conditions. These estimates and judgments are reviewed by senior management and by the Audit Committee on an ongoing basis, at the end of each quarter prior to the public release of our financial results. We believe the following critical accounting policies affect our more significant judgments and estimates used in preparation of our consolidated financial statements.

Revenue Recognition

Net revenue includes product and component sales. The Company recognizes revenue when persuasive evidence of an arrangement exists, delivery has occurred, the sales price is fixed or determinable, and collection is probable. These criteria are met at the time the product is shipped to the customer. Shipping terms are freight on board shipping point. Returns and discounts on sales are deducted from revenue upon issuance of a credit memo. Returns for products under warranty are repaired and returned to the customer at the Company's cost. The Company provides for an estimate of costs that may be incurred under its warranty at the time product revenue is recognized. The Company had a warranty reserve of $54,000 at both March 31, 2004 and December 31, 2003.

Allowance for Doubtful Accounts

We maintain allowances for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. If the financial condition of our customers or channel partners were to deteriorate, resulting in an impairment of their ability to make payments, additional allowance may be required.

Excess and Obsolete Inventory

We write down our excess and obsolete inventory equal to the difference between the cost of inventory and the estimated market value based upon assumptions about future product life-cycles, product demand, and market conditions. If actual product life cycles, product demand and market conditions are less favorable than those projected by management, additional inventory write-downs may be required.

Deferred Taxes

We estimate our actual current tax exposure together with our temporary differences resulting from differing treatment of items for tax and accounting purposes. These temporary differences result in deferred tax assets and liabilities. We must then assess the likelihood that our deferred tax assets will be recovered from future taxable income and to the extent we believe that recovery is not likely, we must establish a valuation allowance. At March 31, 2004 we had provided a valuation allowance for the entire amount of tax assets net of tax liabilities. To the extent that we increase or decrease a valuation allowance in a period, the resulting expense or benefit is included within the tax provision. Significant management judgment is required in determining the provision for income taxes, deferred tax assets and liabilities and any valuation allowance recorded against net deferred tax assets.

Intangibles

We assess the impairment of identifiable intangibles annually or whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Significant under performance relative to projected operating result, changes is the manner of our use of the acquired assets and significant negative industry or economic trends are the more significant indicators that we consider. Any resulting impairment loss could have a material adverse impact on our financial condition and results of operations.

Determining Functional Currencies for the Purpose of Consolidation

Our majority owned Korean subsidiary and Chinese joint venture represent the vast majority of our revenues, assets, and liabilities at March 31, 2004. In preparing our consolidated statements, we are required to translate the financial statements of the foreign entity from the currency in which they keep their accounting records, generally the local currency, into United States dollars. This process results in exchange gains and losses which, under the relevant accounting guidance are either included within the statement of operations or as a separate part of our net equity under the caption "cumulative translation adjustment."

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 unaudited Condensed 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 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 to meet these requirements or that financing will be available at favorable terms when required, or at all. We have experienced significant shortages in our cash flows and have experienced difficulties in funding our operating expenses and paying our creditors. We believe our current capital resources are insufficient to meet currently anticipated capital requirements over the next 12 months, so if we are not successful in raising capital, we may not meet our financial obligations to our creditors when they become due or we may have to curtail or cease certain operations.

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 three months ended March 31, 2004 and during the year ended December 31, 2003, we have incurred substantial net losses in the past, as recently as, among others, fiscal years ended March 31, 2002, 1999, 1998 and 1997. We also expect to generate losses as we continue our spending on personnel and engineers in connection with our research and development efforts related to new product development during 2004 and our expansion into the Indian DVD market. 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:

- market acceptance of our new products;
- ability of our customers to complete their development of products which incorporate our products;
- 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;
- difficulties in forecasting, planning and management of inventory levels, particularly given our ongoing implementation of our new ERP system in Korea, which may trigger inventory adjustments;
- the availability, timely delivery and cost of components from our suppliers;
- 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;
- competitive pressures and related changes in selling prices;
- 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;
- 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;
- 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 consist 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 would likely harm our operating results.

Our growth and future profitability depend upon our ability to successfully develop and commercialize new DVD products, as well as market acceptance of such products.

During the last three years, a substantial amount of our 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. We have recently experienced a declining rate of revenues from sales of our DVD loaders as a result of a decrease in demand from our customers. 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, as well as market acceptance of such products, is essential to our achieving positive gross margins as well as growth and future profitability. While we are currently developing and introducing new products, 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 continue to invest heavily in research and development personnel and engineers during 2004, which will likely adversely impact achievement of near term profitability.

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

Sales of products overseas accounted for 99.7%, 98.1%, 99.0%, 99.6% and 99.9% of our revenue in the nine-month period ended December 31, 2000, the fiscal year ended December 31, 2001, the fiscal year ended December 31, 2002, the fiscal year ended December 31, 2003 and the three month period ended March 31, 2004, 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:

- impact of currency fluctuations for which the Company has no hedging activity;
- difficulties in complying with foreign regulatory requirements and standards;

- greater difficulty in ensuring adequacy of our disclosure controls and procedures and internal control over financial reporting with respect to international operations;
- 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 have offices and conduct our operations in China, South Korea, and most recently India. We have 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, North Korea and South Korea and India and Pakistan, which are continuously engaged in political disputes. Some of these countries have from time to time 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 revenue, our revenue could decline due to the loss of one of these customers.

Products sold to our top five customers accounted for approximately 60% and 67% of our revenue during the year ended December 31, 2003 and the three month period ended March 31, 2004, respectively. Products sold to our top 10 customers accounted for approximately 88%, 67%, 78% and 88% of our revenue during the fiscal years ended December 31, 2001, 2002, and 2003, and the three month period ended March 31, 2004, respectively. In the quarter ended March 31, 2004, Ellion Digital, Inc., an entity in which certain officers, directors and employees of our Korean subsidiary have a significant ownership interest, Kaixinda, Farimex and Vestel accounted for 22%, 18%, 16% and 11% of our revenue, respectively. In the fiscal year ended December 31, 2003, Ellion Digital, Daewoo, and Vestel accounted for 20%, 16%, and 13% 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, owner of 39% of our Chinese joint venture, 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.

The dynamic nature of our business continues to place a significant strain on our management systems and resources, and if we fail to manage the changes in our products, markets and supply chain, our ability to market and sell our products and develop new products may be harmed.

Our business is experiencing rapid change 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 are implementing an ERP system, there is no guarantee that this system and any new systems implemented in the future will be adequate to address the rapid changes in sales volume, product mix, regional mix, and supply chain which we anticipate, or that management will be able to foresee in a timely manner other infrastructure needs before they arise. In addition, we have in the past and may in the future experience problems with the ERP system, particularly as it is being implemented, which problems may lead to inventory management issues. Our success depends on the ability of our executive officers to effectively manage in this rapidly changing environment. If we are unable to manage our growth effectively, our results of operations will be seriously harmed.

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 will need to 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 $28.7 million as of May 10, 2004. 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 will need to sell shares of our common stock or seek additional borrowings or outside capital infusions in the next twelve months. 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.

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 whom we are currently working, together with any additional suppliers, 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 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 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;
- 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 business 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. The impact of any 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, we might fall short of our revenue expectations for any given quarter or for the entire year in which a slowdown takes place.

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 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.

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

In order to grow, we may need to increase our present manufacturing capacity. Events that we have not foreseen could arise which would limit our manufacturing capacity or outsource manufacturing. 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.

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.

If we account for employee stock options using the fair value method, it could significantly increase our net loss.

There has been ongoing public debate whether stock options granted to employees should be treated as a compensation expense and, if so, how to properly value such charges. On March 31, 2004, the Financial Accounting Standard Board (FASB) issued an Exposure Draft, *Share-Based Payment: an amendment of FASB statements No. 123 and 95*, which would require a company to recognize, as an expense, the fair value of stock options and other stock-based compensation to employees beginning in 2005 and subsequent reporting periods. If we elect or are required to record an expense for our stock-based compensation plans using the fair value method as described in the Exposure Draft, we could have significant and ongoing accounting charges, which could adversely affect our future results.

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.

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 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. Our new products currently being developed are in the DVD product line, particularly automotive and read/write DVD products. The sales of our DVD loaders are related to the markets for DVD video disks and DVD video players. If we experience an unforeseen downturn in the markets for DVD video disks 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 approximated market value, and investments in marketability debt securities are carried at amortized cost, which approximates market value.

Foreign Currency Risk

We develop products in the United States, Korea, China and India and market our products in the Asia-Pacific region, North America and India. 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. We do not currently engage in any hedging activities to mitigate this risk.

Item 4. Controls and Procedures

(a) 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, except as noted in the following paragraphs, to ensure that information we are required to disclose in reports that we file or submit under the Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms.

During our fiscal year 2003 financial reporting process, the Company's Chief Executive Officer and Chief Financial Officer, in consultation with the Company's independent accountants, identified the following deficiencies which constitute a "reportable condition" as defined under standards established by the American Institute of Certified Public Accountants:

- processing and monitoring of work-in-process inventory resulting from implementation of a new enterprise resource planning system (ERP); and

- processing and monitoring of intercompany profits in inventory.

The ERP problems identified during the fiscal 2003 reporting process were not fully resolved by the end of our first quarter and accordingly, we were not able to accurately determine inventory levels using our ERP system as of March 31, 2004. However, based on the results of a physical inventory of the major portion of high dollar items at DVSK conducted on March 31, 2004, the inventory amount was correctly adjusted as of the end of the period.

(b) Changes in internal control over financial reporting.

There was no change in our internal control over financial reporting that occurred during our current quarter that materially affected, or is reasonably likely materially to affect, our internal control over financial reporting, except that we continued our efforts to correct the inventory management problems that developed during fiscal 2003 when we began to install a new ERP system to address, among other matters, inventory management.

More specifically, under the direction of the Audit Committee and the Board of Directors, senior management directed the Company to dedicate resources and to take steps to strengthen control processes in order both to identify and prevent the situation that resulted in the year end adjustments for book-to-physical and intercompany profits in inventory. To this end, the Company began during the quarter ended March 31, 2004 to take the following immediate steps:

- working on re-programming the enterprise resource planning system to eliminate the system deficiency that lead to the book-to-physical inventory adjustment; and

- performing physical inventories on the major portion of high dollar items at DVSK on a quarterly basis;

The Company continues to evaluate the need for further improvements, including further formalizing its processes, procedures and policies, to its internal control over financial reporting and disclosure controls and procedures.

Limitations on the Effectiveness of Controls

The Company's management, including the CEO and CFO, does not expect that our disclosure and controls and procedures or our internal control over financial reporting will prevent all error and all fraud. A control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the control system's objectives will be met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty and that breakdowns can occur because of simple error or mistake. Controls can also be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the controls. The design of any system of controls is based in part on certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Over time, controls may become inadequate because of changes in conditions or deterioration in the degree of compliance with policies or procedures. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

We are from time to time a party to various legal proceedings arising in the ordinary course of our business. The outcome of any pending legal matters may have a material adverse effect on our business, operating results or financial condition.

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. The complaint has been served on Mr. Chen and Ms. Kuo but the Company has not yet been able to serve the other named defendants as they are residing outside of the United States. As of March 31, 2004, the Company had received Mr. Chen and Ms. Kuo's counterclaims. The Company has established an accrual of $650,000 for wages and expenses related to prior employment, and believes that it has meritorious defenses to all other claims.

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

During the quarterly period ended March 31, 2004, we sold 1,212,121 shares of our common stock to a group of purchasers for $1.65 per share. The gross proceeds were approximately $2.0 million. 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 of 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

The Company filed a Form 8-K on February 24, 2004, furnishing a press release, dated as of February 17, 2004, providing guidance on the fourth quarter of 2003.

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 17, 2004

DIGITAL VIDEO SYSTEMS, INC.

By: /s/ THOMAS SPANIER
Thomas Spanier
Chief Executive Officer
(Principal Executive Officer)

/s/ DOUGLAS T.WATSON
Douglas T. Watson
Acting Chief Financial Officer
(Principal Accounting and Financial Officer)

EXHIBIT INDEX

Exhibit No.		Description
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.