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 June 30, 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

DVS

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 June 30, 2004, there were approximately 10,702,179 shares of the registrant's common stock outstanding.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

Digital Video Systems, Inc.
Condensed Consolidated Balance Sheets
(in thousands)
(Unaudited)

	June 30, 2004	December 31, 2003
ASSETS		
Current assets:		
Cash and cash equivalents	$ 1,946	$ 6,444
Restricted cash	6,669	6,186
Marketable debt securities	724	423
Accounts receivable, net	1,561	2,045
Accounts receivable - related party	1,731	3,176
Inventories, net	15,623	24,645
Prepaid expenses and other current assets	2,148	2,081
Note receivable - related party	568	732
Total current assets	30,970	45,732
Property and equipment, net	12,270	12,639
Intangibles, net	210	335
Other assets	436	65
Total assets	$ 43,886	$ 58,771
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Line of credit	$ 19,878	$ 26,051
Notes payable	--	3,603
Notes payable - related party	--	60
Accounts payable	10,895	11,903
Accounts payable - related party	239	524
Other payables	2,342	626
Accrued liabilities	2,666	1,953
Total current liabilities	36,020	44,720
Minority interest	5,820	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; 10,702,179 and 8,881,090 shares issued and outstanding, respectively	1	1
Additional paid-in capital	80,728	77,650
Deferred compensation	--	(1)
Accumulated other comprehensive loss	1,690	1,521
Accumulated deficit	(80,373)	(73,306)
Total stockholders' equity	2,046	5,865
Total liabilities and stockholders' equity	$ 43,886	$ 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 June 30, 2004	Three Months Ended June 30, 2003	Six Months Ended June 30, 2004	Six Months Ended June 30, 2003
Net revenue	$ 32,732	$ 23,244	$ 50,254	$ 50,926
Cost of revenue	30,271	20,304	48,785	47,364
Gross margin	2,461	2,940	1,469	3,562
Operating expenses:				
Research and development	1,300	1,356	3,045	2,669
Sales and marketing	1,119	762	2,050	1,562
General and administrative	2,836	1,465	5,161	3,489
Total operating expenses	5,255	3,583	10,256	7,720
Loss from operations	(2,794)	(643)	(8,787)	(4,158)
Interest expense	(251)	(291)	(568)	(543)
Other income (expense), net	(324)	(312)	(385)	587
Loss before minority interest and income taxes	(3,369)	(1,246)	(9,740)	(4,114)
Income tax benefit	--	(2)	--	(2)
Minority interest	990	339	2,673	1,218
Net loss	$ (2,379)	$ (909)	$ (7,067)	$ (2,898)
Basic and diluted net loss per share	$ (0.23)	$ (0.13)	$ (0.71)	$ (0.43)
Weighted average common shares and equivalent outstanding	10,311	6,832	9,969	6,726

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)

	Six Months Ended June 30, 2004	Six Months Ended June 30, 2003
Cash flows from operating activities:		
Net loss	$ (7,067)	$ (2,898)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Minority interest	(2,366)	(1,218)
Depreciation and amortization	1,686	1,217
Issuance of common stock for service provided	120	--
Writedown of notes receivable	164	--
Amortization of deferred compensation	1	9
Stock compensation expense	320	--
Changes in operating assets and liabilities:		
Accounts receivable and accounts receivable - relatee party	1,929	3,127
Inventories	9,022	3,534
Prepaid expenses and other current assets	(67)	171
Other assets	(371)	(78)
Accounts payable and accounts payable related party	(1,293)	(2,496)
Accrued liabilities	713	(105)
Other payable	1,716	(17)
Net cash provided by operating activities	4,507	1,246
Cash flows from investing activities:		
Acquisition of property and equipment	(1,192)	(2,122)
(Purchases) maturities of marketable debt securities	(301)	8
Increase in restricted cash	(483)	(483)
Net cash used in investing activities	(1,976)	(2,597)
Cash flows from financing activities:		
Proceeds from the sale of common shares, net	2,002	214
Proceed from the exercise of options and warrants	636	112
(Repayment of) proceeds from line of credit	(6,173)	447
Proceeds from notes payable	3,000	259
Repayment of notes payable and notes payable-related party	(6,663)	(97)
Net cash provided by (used in) financing activities	(7,198)	935
Effect of exchange rate changes	169	93
Net decrease in cash and cash equivalents	(4,498)	(323)
Cash and cash equivalents at beginning of period	6,444	12,330
Cash and cash equivalents at end of period	$ 1,946	$ 12,007

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 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 and six-month periods ended June 30, 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 46was 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 were delayed and apply to the first fiscal year or interim period beginning after December 15, 2003. We do not have any entities as of June 30, 2004 that will require disclosure or new consolidation as a result of adopting the provisions of FIN 46.

In April 2004, the Emerging Issues Task Force issued Statement No. 03-06, (EITF 03-06), *Participating Securities and the Two-Class Method under FASB Statement No. 128, Earnings Per Share*. EITF 03-06 which addresses a number of questions regarding the computation of earnings per share by companies that have issued securities other than common stock that contractually entitle the holder to participate in dividends and earnings of the company when, and if, it declares dividends on its common stock. The issue also provides further guidance in applying the two-class method of calculating earnings per share, clarifying what constitutes a participating security and how to apply the two-class method of computing earnings per share once it is determined that a security is participating, including how to allocate undistributed earnings to such a security. EITF 03-06 was effective for fiscal periods beginning after March 31, 2004. The adoption of EITF 03-06 did not have a material effect on the Company's results of operations or financial position.

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 June 30,		Six Months Ended June 30,	
(in thousands, except per share amounts)	**2004**	**2003**	**2004**	**2003**
Reported net loss	$ (2,379)	$ (909)	$ (7,067)	$ (2,898)
Add: Stock-based compensation, as reported	1	4	1	9
Deduct: Total stock-based compensation determined under fair value based method for all awards	(126)	(153)	(252)	(274)
Adjusted net loss, fair value method for all stock-based awards	$ (2,504)	$ (1,058)	$ (7,318)	$ (3,163)
Basic and diluted loss per share - as reported	$ (0.23)	$ (0.13)	$ (0.71)	$ (0.43)
Basic and diluted loss per share - proforma	$ (0.24)	$ (0.15)	$ (0.73)	$ (0.47)

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 June 30,		Six Months Ended June 30,	
	2004	**2003**	**2004**	**2003**
Weighted average risk-free interest rates	--	1.57%	1.81%	1.57%
Average expected life (in years)	--	2.0	2.0	2.0
Volatility	--	109%-125%	155%	109%-125%

No options were granted during the three months ended June 30, 2004. The weighted average grant date fair value of stock awards granted during the three months ended June 30, 2003 was $0.95 per share. The weighted average grant date fair value of stock awards granted during the six months ended June 30, 2004 and 2003 was $1.41 and $1.03 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 June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
Net loss	$ (2,379)	$ (909)	$ (7,067)	$ (2,898)
Weighted average common shares outstanding(1)	10,561	6,832	10,219	6,726
Weighted average unvested restricted stock(1)	(250)	--	(250)	--
Weighted average common shares outstanding - basic(1)	10,311	6,832	9,969	6,726

(1) At June 30, 2004 and 2003, 4,538,518 and 2,755,825 shares underlying options and warrants, respectively, were excluded from the calculation of the diluted earnings per share calculation 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 June 30,		Six Months Ended June 30,	
	2004	2003	2004	2004
Net loss	$ (2,379)	$ (909)	$ (7,067)	$ (2,898)
Cumulative foreign currency translation adjustments	(212)	734	169	48
Comprehensive loss	$ (2,591)	$ (175)	$ (6,898)	$ (2,850)

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):

	June 30, 2004	December 31, 2003
Inventories:		
Raw materials	$ 9,170	$ 16,716
Work-in-process	3,995	2,892
Finished goods	4,478	6,124
Total inventory	17,643	25,732
Less inventory reserves	(2,020)	(1,087)
Net inventory	$ 15,623	$ 24,645

Intangible assets consisted of the following (in thousands):

	June 30, 2004	December 31, 2003
Intangible assets of acquired businesses	$ 2,400	$ 2,400
Less: accumulated amortization	(2,190)	(2,065)
	$ 210	$ 335

7. Geographic 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 are as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	**2003**	**2004**	**2003**
Geographic:				
Domestic	$ 1,173	$ 163	$ 1,770	$ 321
Asia	27,645	20,770	42,242	40,583
Europe	2,219	128	3,542	271
Other international countries	1,695	2,183	2,700	9,751
Total sales	$ 32,732	$ 23,244	$ 50,254	$ 50,926

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 six months ended June 30, 2004 (in thousands):

	June 30, 2004
Warranty accrual, beginning of period	$ 54
Charged to cost of sales	61
Actual warranty expenditures	(91)
Warranty accrual, end of period	$ 24

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% or more of total revenues, are summarized as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
Customer A	27%	*	24%	*
Customer B	26%	*	24%	*
Customer C	*	33%	*	24%
Customer D	*	*	*	16%

(* = less than 10%)

Ellion Digital, Inc., a company in which certain of the employees, officers and directors of the Company's subsidiary in Korea have a significant ownership interest, accounted for approximately 26.1% of the Company's total revenue for the three months ended June 30, 2004. Ellion Digital, Inc. comprised 41.6% of the combined total of accounts receivable and accounts receivable from related party at June 30, 2004.

The Company currently buys 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. The Company anticipates that these suppliers will manufacture sufficient quantities of these key components to meet its production requirements. If these suppliers fail to satisfy the Company's requirements on a timely basis and at competitive prices, the Company could suffer manufacturing delays, a possible loss of revenues or higher than anticipated costs of revenues, any of which could seriously harm the Company's operating results. Any constraints on worldwide manufacturing capacity of these key components may affect the Company's ability to obtain adequate supplies from these manufacturers.

10. Common Stock

In January 2004, the Company sold 1,212,121 shares of its 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 the initial funding of DVS Electronics, Pvt. Ltd., (DVSE), the Company's subsidiary in India which was formed in 2003.

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 has used the proceeds from the warrant exercise for general corporate purposes. In connection with the warrant repricing the Company incurred a warrant modification charge of $0.2 million in the second quarter of 2004.

11. Legal Matters

On June 24, 2002, the Company filed a lawsuit in the Santa Clara County Superior Court against Mali Kuo, Michael Chen, and Meng Tek Ung, former directors, officers and employees of the Company. The Company's lawsuit includes causes of action for breach of fiduciary duties, breach of duty of loyalty, negligent performance of employment duties and breach of employment agreements. The defendants have filed cross-claims and fraud claims arising from their employment agreements. The Company has established an accrual of $0.7 million for wages and expenses related to prior employment of Mr. Chen and Ms. Kuo. The Company is contesting the claims against it vigorously and is asserting affirmative claims for relief.

In March 2004, the former CEO of the Company's Korean subsidiary, based on claimed severance payments, obtained an ex-parte writ of attachment on certain shares of the Company's stock in this subsidiary. The Company, which became aware of the attachment in June 2004, intends to initiate a legal action to release this writ of attachment. The Company is not aware at this time whether the former CEO has commenced any legal action for the claimed severance payments in connection with this writ of attachment.

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 second quarter of 2004, the Company repaid $4.8 million of notes payable to a Chinese bank. The Company also repaid $3.4 million on its credit line with its Korean banks in the second quarter, reducing the amount outstanding under its line of credit to $19.9 million. The total borrowing limit as of June 30, 2004 with these Korean banks was $23.4 million.

13. Subsequent Events

In July 2004, the Company obtained two loans with a Chinese bank for $1.8 million each. The loans are collateralized by the Company's facility in China and have a one-year term with interest at LIBOR plus 0.7%.

In July 2004, the Company reached a settlement concerning legal fees owed to a law firm by issuing 335,000 shares of its common stock. The stock had a fair market value on the settlement date of $271,000.

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 and six months ended June 30, 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 adequate capital for operations, 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 South 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 we would no longer be able to generate acceptable margins from the sale of these products. Accordingly, we have 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. These new automotive and read/write products have the potential for higher margins and we anticipate that they will favorably impact our gross margins in future periods to the extent revenues derived from them increase.

During the second quarter of 2004, sales of our read-write products increased significantly and accounted for 66% our total revenues. In addition, sales of our automotive DVD products accounted for 11% of our total revenues. Our gross margin of 8% in the second quarter was also influenced by revenues from our older DVD loaders which have a low gross margin and inventory charges primarily related to the discontinuance of certain DVD products. This is an improvement from the negative gross margin of (6%) incurred during the first quarter, and we anticipate further improvements in future quarters to the extent sales of the read-write and especially the automotive DVD products increase.

Working capital declined from $1.0 million at December 31, 2003 to a $5.1 million deficit at June 30, 2004. Our line of credit with banks in South Korea has been reduced to $22.3 million at July 28, 2004 and further reductions are possible going forward. Moreover, our operations in the United States will require additional funding. Consequently, an infusion of equity and/or debt subordinate to our existing bank debt will 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 June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
Revenue	$ 32,732	$ 23,244	$ 50,254	$ 50,926
Gross profit	2,461	2,940	1,469	3,562
Loss from operations	(2,794)	(643)	(8,787)	(4,158)
Net loss	(2,379)	(909)	(7,067)	(2,898)

Sales of our read-write products increased substantially during the second quarter of 2004. These sales, combined with the introduction of our new automotive products, resulted in a 41% increase in revenues as compared to the second quarter of 2003. Due to the continuing sale of our low margin DVD loaders and inventory charges, our gross margins of 8% for the second quarter of 2004, while improving significantly from the first quarter of 2004, were less than the 12.6% achieved in the second quarter of 2003. We anticipate that increased sales of our automotive DVD products, in combination with increased sales of our read-write products and decreased sales of our DVD loaders, will result in improved gross margins in future periods. The availability of parts and working capital, however, may limit any growth in revenues. Further, because of the minority interest in DVSK, the Company will not fully realize all of DVSK's earnings when and if DVSK returns to profitability. Consequently, we anticipate that we are likely to incur net losses for at least the next quarter.

The Three Months Ended June 30, 2004
Compared to the Three Months Ended June 30, 2003

The following table sets forth certain income and expense items expressed as a percentage of the Company's total revenue for the three month period ended June 30, 2004 compared with the three month period ended June 30, 2003.

	Three Months Ended June 30,	
Percent of Revenue	2004	2003
Revenue	100.0 %	100.0 %
Gross margin	7.5 %	12.6 %
Research and development	4.0 %	5.8 %
Sales and marketing	3.4 %	3.3 %
General and administration	8.7 %	6.3 %
Loss from operations	(8.5)%	(2.8)%
Net loss	(7.3)%	(3.9)%

	Three Months Ended June 30,		%
Consolidated Revenue	2004	2003	Change
Amount (in thousands)	$ 32,732	$ 23,244	41 %

Total revenue increased by $9.5 million, or 41%, for the three months ended June 30, 2004 as compared with the three months ended June 30, 2003. This increase is primarily attributable to the significant increase in sales of our read-write products, and, to a lesser extent, sales of our automotive DVD products. In the quarter ended June 30, 2004, Kaixinda and Ellion Digital, Inc. accounted for 27.2% and 26.1% of our revenue, respectively. In the quarter ended June 30, 2003, Daewoo accounted for 33% of our revenue. Ellion Digital, Inc., is a Korean DVD player manufacturer in which certain officers, directors and employees of DVSK have a significant ownership interest. The revenue generated from Ellion Digital is primarily related to the production of complete DVD systems. We are inquiring into the relationship between DVSK and Ellion. We have received an updated report on this relationship that we are reviewing with counsel, but require additional time and information to draw meaningful conclusions.

Gross Profit	Three Months Ended June 30, 2004	2003	% Change
Amount (in thousands)	$ 2,461	$ 2,940	(16)%
As a percentage of revenue	7.5 %	12.6 %	--

The decrease in the gross margin in the second quarter of 2004 as compared to the second quarter of 2003 is attributable to the continuing sale of our low margin DVD loaders and components. In addition, we increased our inventory reserves by $0.5 million provision, or 1.5% of revenues, during the second quarter of 2004 for obsolete and excess inventories while not incurring such charges in the second quarter of 2003.

Our products engineering group in South Korea has developed and intends to continue to develop DVD products 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 as anticipated and our results of operations and financial position will be harmed significantly.

Research and Development	Three Months Ended June 30, 2004	2003	% Change
Amount (in thousands)	$ 1,300	$ 1,356	(4)%
As a percentage of revenue	4.0 %	5.8 %	--

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. We expect to continue spending at approximately the same rate in absolute dollar terms during 2004.

Sales and Marketing	Three Months Ended June 30, 2004	2003	% Change
Amount (in thousands)	$ 1,119	$ 762	47 %
As a percentage of revenue	3.4 %	3.3 %	--

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 $0.4 million increase in expenses comparing the periods is primarily due to the establishment of our subsidiary in India which incurred $0.2 million of sales and marketing expense in the second quarter of 2004, and $0.2 million of additional expenses at our China joint venture.

General and Administrative	Three Months Ended June 30, 2004	2003	% Change
Amount (in thousands)	$ 2,836	$ 1,465	94 %
As a percentage of revenue	8.7 %	6.3 %	--

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 general and administrative expenses of $1.4 million in the second quarter of 2004 as compared to the second quarter of 2003 is due primarily to a $0.4 million increase in spending at the Company due to $0.2

million of non-cash warrant and stock option compensation and $0.1 million of increased legal fees, a $0.2 million increase at our China joint venture, and a $0.4 million increase at DVSK primarily due to a provision for bad debt. In addition, the Company recorded a $0.4 million reversal of general and administrative expenses in the second quarter of 2003 due to a favorable settlement of fees owed a former auditor.

Other Income / (Expense)	Three Months Ended June 30, 2004	Three Months Ended June 30, 2003	% Change
Amount (in thousands)	$ (324)	$ (312)	4 %
As a percentage of revenue	(1.0)%	(1.3)%	--

Other expense of $0.3 million in the three months ending June 30, 2004 consisted primarily of $0.8 million of other expenses partially offset by an exchange gain of $0.4 million. In the three months ended June 30, 2003, other expense of $0.3 million consisted primarily of an exchange loss of $0.2 million and other expenses of $0.1 million.

Interest expense of $0.2 million and $0.3 million in the three months ending June 30, 2004 and 2003, respectively, consisted primarily of costs associated with borrowings outstanding during the quarters.

The Six Months Ended June 30, 2004
Compared to the Six Months Ended June 30, 2003

The following table sets forth certain income and expense items expressed as a percentage of the Company's total revenue for the six month period ended June 30, 2004 compared with the six month period ended June 30, 2003.

Percent of Revenue	Six Months Ended June 30, 2004	Six Months Ended June 30, 2003
Revenue	100.0 %	100.0 %
Gross margin	2.9 %	7.0 %
Research and development	6.1 %	5.2 %
Sales and marketing	4.1 %	3.1 %
General and administration	10.3 %	6.9 %
Loss from operations	(17.5)%	(8.2)%
Net loss	(14.1)%	(5.7)%

Consolidated Revenue	Six Months Ended June 30, 2004	Six Months Ended June 30, 2003	% Change
Amount (in thousands)	$ 50,254	$ 50,926	(1)%

Total revenue decreased by $0.7 million, or 1%, for the six months ended June 30, 2004 as compared with the six months ended June 30, 2003. This decrease is primarily attributable to the decrease in sales of our legacy DVD products, partially offset by the significant increase in the second quarter of 2004 in sales of our read-write products, and, to a lesser extent, sales of our automotive DVD products. In the six months ended June 30, 2004, Kaixinda and Ellion Digital, Inc. accounted for 24.1% and 24.0% of our revenue, respectively. In the six months ended June 30, 2003, Daewoo accounted for 24% of our revenue.

Gross Profit	Six Months Ended June 30, 2004	2003	% Change
Amount (in thousands)	$ 1,469	$ 3,562	(59)%
As a percentage of revenue	2.9 %	7.0 %	--

The decrease in the gross margin in the first six months of 2004 compared to the first six months of 2003 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 $0.9 million increase in inventory reserves, or 1.4% of revenues, during the first half of 2004 for obsolete and excess inventories.

Research and Development	Six Months Ended June 30, 2004	2003	% Change
Amount (in thousands)	$ 3,045	$ 2,669	14 %
As a percentage of revenue	6.1 %	5.2 %	--

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. Research & development spending increased by $0.4 million, or 14%, primarily due to the addition of engineers and support staff at DVSK to accelerate the development of the new product programs for the automotive and DVD read/write markets. We expect to continue research and development spending at approximately the same rate in absolute dollar terms during 2004.

Sales and Marketing	Six Months Ended June 30, 2004	2003	% Change
Amount (in thousands)	$ 2,050	$ 1,562	31 %
As a percentage of revenue	4.1 %	3.1 %	--

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 South Korea, China, India and the United States. The $0.5 million increase in expenses comparing the periods is primarily due to the establishment of our subsidiary in India which incurred $0.3 million of sales and marketing expense in the first six months of 2004, and $0.2 million of additional expenses at our China joint venture.

General and Administrative	Six Months Ended June 30, 2004	2003	% Change
Amount (in thousands)	$ 5,161	$ 3,489	48 %
As a percentage of revenue	10.3 %	6.9 %	--

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 the first half of 2004 as compared to the first half of 2003 in general and administrative expenses of $1.7 million is due to a $0.5 increase in spending at the Company which is due to $0.3 million of non-cash warrant and stock option compensation and $0.2 million of increased legal fees, $0.1 million at our Mobiletouch subsidiary established in 2003, a $0.2 million increase at our China joint venture and a $0.4 million increase at DVSK, primarily do to a provision for bad debts. In addition, the Company recorded a $0.4 million reversal of general and administrative expenses due to the favorable settlement of its litigation with a former auditor in the second quarter of 2003.

Other Income / (Expense)	Six Months Ended June 30, 2004	2003	% Change
Amount (in thousands)	$ (385)	$ 587	(166)%
As a percentage of revenue	(0.8)%	1.2 %	--

Other expense of $0.4 million in the six months ended June 30, 2004 consisted primarily of $0.6 million of other expenses partially offset by $0.2 million of exchange gains. In the six months ended June 30, 2003 other income of $0.6 million consisted primarily of an exchange gain of $0.4 million and interest income of $0.2 million.

Interest expense of $0.6 million and $0.5 million in the six months ended June 30 and 2003, respectively, consisted primarily of costs associated with borrowings outstanding during the respective six-month periods.

Liquidity and Capital Resources

At June 30, 2004, the Company had $8.6 million of cash and equivalents, of which $6.7 million was restricted as collateral for lines of credit.

Net cash provided by operating activities was $4.5 million during the first half of 2004. During the six month period, we experienced a net loss of $7.1 million, adjusted by the non-cash reduction in the minority interest of the investors of our DVSK subsidiary and China joint venture of $2.4 million. Inventories decreased by $9.0 million as the market opened for our new read-write DVD products, enabling us to ship inventory on hand, our ongoing liquidation of our legacy DVD products, and the increased inventory reserve provisions. Accounts receivable and accounts receivable – related party decreased by $1.9 million as we were able to obtain improved credit terms from our customers due to the sale of our new products. Other payables increased by $1.7 million, and depreciation and amortization was $1.7 million. These sources of funds were partially offset by a decrease in accounts payable and accounts payable – related party of $1.3 million.

Net cash provided by operating activities in the first half of 2003 was $1.2 million. Cash was provided as accounts receivable and inventories declined by $3.1 million and $3.5 million, respectively, and prepaid expenses and other current assets decreased by $0.1 million, and non-cash charges for depreciation and amortization were $1.2 million.

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

	Twelve Months Ended June 30, 2004	2003
Inventory turn	4.3 X	5.2 X
Receivable turn	14.7 X	14.9 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 are likely to be higher than in the previous twelve-month period as the Company is attempting to obtain faster payments and prepayments terms on its new products. If these efforts are successful, receivable turns should improve as sales of these products increase.

Net cash used in investing activities was $2.0 million for the six months ended June 30, 2004, which consisted of the acquisition of $1.2 million of property and equipment, primarily tooling and equipment in Korea, purchases of marketable debt securities of $0.3 million and an increase in restricted cash of $0.5

million. Net cash used in investing activities was $2.6 million for the six months ended June 30, 2003, which primarily consisted of an increase in restricted cash of $0.5 million and the acquisition of $2.1 million of property and equipment. Tooling for new products in the period totaled $0.6 million, leasehold improvements to the new production facilities in Korea and China totaled $1.1 million, and the remaining $0.4 million was an investment in factory and computer equipment.

Net cash used in financing activities was $7.2 million for the six months ended June 30, 2004. We repaid $6.2 million on our line of credit with our Korean banks. We repaid $6.7 million of notes payable to our Chinese bank, after receiving $3.0 million of proceeds. The cash provided by financing activities in this period was primarily from the $2.0 million in proceeds from the sales of shares of common stock and $0.6 million from the exercise of options and warrants. 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. 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 a 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.

Net cash provided by financing activities was $0.9 million for the six months ended June 30, 2003. The cash provided by financing activities was primarily borrowings of $0.4 million from a line of credit, $0.3 million from notes payable, and $0.3 million of proceeds from the sale of shares of common stock and the exercise of options and warrants.

Our working capital deficit is $5.1 million at June 30, 2004, as compared to working capital of $1.0 million at December 31, 2003. Banks in Asia in general are becoming more restrictive in their lending practices. Consequently, our bank lines in South Korea have been reduced as of July 28, 2004 to $22.3 million due to the adverse effects of change in the banking environment, coupled with our current operating levels and concern over our losses and further reductions are possible. In addition, in June 2004 we repaid all notes owed by our joint venture in China to its bank. We are attempting to offset these reductions in our lines of credit during a period of rapid revenue growth by reducing the credit extended to our largest customer. We have also requested prepayments from our customers on our new products and extended payment terms from our vendors. Because such accommodations are largely at the discretion of our customers and vendors, there is no assurance that we will continue to be successful in these actions. In addition, our operations in the United States will require the raising of additional capital in order to meet currently anticipated requirements. Therefore, we believe that an infusion of equity and/or debt subordinate to our existing bank debt will be required to help fund our operations.

In July 2004, the Company's joint venture in China obtained two loans with the Bank of Shanghai for $1.8 million each. The loans are secured by the joint venture's facility in China and have a one-year term with interest at LIBOR plus 0.7%. We are also currently in discussions with investment firms and anticipate raising capital during the third quarter of 2004. There is no assurance that we 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 significantly curtail our operations.

Contractual Obligations

The following table summarizes our significant contractual obligations at June 30, 2004.

	Payments Due by Period (in 000's)				
Contractual Obligation	**Total**	**Less than 1 year**	**1-3 years**	**4-5 years**	**After 5 years**
Operating lease obligations.......	$ 1,578	$ 715	$ 647	$ 31	$ 185
Line of credit..........................	19,878	19,878	--	--	--
Total contractual obligations...	$ 21,456	$ 20,593	$ 647	$ 31	$ 185

Off-Balance Sheet Arrangements

The Company had no "Off-Balance Sheet Arrangements" (as defined by Item 303 of Regulation S-K) at June 30, 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 June 30, 2004 that will require disclosure or new consolidation as a result of adopting the provisions of FIN 46.

In April 2004, the Emerging Issues Task Force issued Statement No. 03-06, (EITF 03-06), *Participating Securities and the Two-Class Method under FASB Statement No. 128, Earnings Per Share*. EITF 03-06 which addresses a number of questions regarding the computation of earnings per share by companies that have issued securities other than common stock that contractually entitle the holder to participate in dividends and earnings of the company when, and if, it declares dividends on its common stock. The issue also provides further guidance in applying the two-class method of calculating earnings per share, clarifying what constitutes a participating security and how to apply the two-class method of computing earnings per share once it is determined that a security is participating, including how to allocate undistributed earnings to such a security. EITF 03-06 was effective for fiscal periods beginning after March 31, 2004. The adoption of EITF 03-06 did not have a material effect on the Company's results of operations or financial position.

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 $24,000 and $54,000 at June 30, 2004 and December 31, 2003, respectively.

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, an 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 June 30, 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 June 30, 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 six months ended June 30, 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 December 31, 2002, and fiscal years ended March 31, 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 96.4% 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 six month period ended June 30, 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 68% of our revenue during the year ended December 31, 2003 and the six month period ended June 30, 2004, respectively. Products sold to our top 10 customers accounted for approximately 88%, 67%, 78% and 80% of our revenue during the fiscal years ended December 31, 2001, 2002, and 2003, and the six month period ended June 30, 2004, respectively. In the quarter ended June 30, 2004, Ellion Digital, Inc. and Kaixinda accounted for 26.1% and 27.2% 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 enterprise resource planning (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 $23.4 million as of June 30, 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, Philips 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 $0.77 on July 26, 2004. 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 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 products 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 products, our results of operations from our DVD products 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 borrowings and our investment portfolio. Our borrowings consist primarily of amounts outstanding under our lines of credit, which totaled approximately $20 million at June 30, 2004. While the interest rates under our credit lines are fixed, because the terms of such lines are relatively short, they must frequently be renewed, at which time their interest rates are reset based upon prevailing rates. We do not use derivative financial instruments in our investment portfolio. The primary objective of our investment activities is to preserve principal while maximizing yields without significantly increasing risk. Our investments consist primarily of commercial paper and certificates of deposits. Due to the nature of our investments, we believe that there is no material risk exposure. Cash equivalents and short-term investment are carried at cost, which approximates market value, and investments in 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, Europe, 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. We believe that the problems with the ERP were corrected as of June 30, 2004, and we did not incur any material adjustment as a consequence of a physical inventory of the major portion of high dollar items at DVSK conducted on June 30, 2004. However, we will continue to monitor the system.

(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 to materially 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 to both 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 ERP 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, and Meng Tek Ung, former directors, officers and employees of the Company. The Company's lawsuit includes causes of action for breach of fiduciary duties, breach of duty of loyalty, negligent performance of employment duties and breach of employment agreements. The defendants have filed cross-claims and fraud claims arising from their employment agreements. The Company has established an accrual of $0.7 million for wages and expenses related to prior employment of Mr. Chen and Ms. Kuo. The Company is contesting the claims against it vigorously and is asserting affirmative claims for relief.

In March 2004, the former CEO of the Company's Korean subsidiary, based on claimed severance payments, obtained an ex-parte writ of attachment on certain shares of the Company's stock in this subsidiary. The Company, which became aware of the attachment in June 2004, intends to initiate a legal action to release this writ of attachment. The Company is not aware at this time whether the former CEO has commenced any legal action for the claimed severance payments in connection with this writ of attachment.

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 June 30, 2004, the Company issued the following shares of unregistered securities:

Thirteen investors (including three holders of placement agents' warrants – discussed in the following paragraph) exercised outstanding warrants for an aggregate of 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.

Three holders of placements agents' warrants issued in the July 2003 financing exercised their 20,000 warrants at an exercise price of $1.40 per warrant (for proceeds of $28,000), resulting in the issuance of an aggregate of 20,000 shares of common stock and 20,000 warrants identical to the warrants issued to the investors in the July 2003 financing. These three warrant holders then exercised the underlying 20,000 warrants as part of the warrant reduction offering described above.

The above transactions were exempt from registration pursuant to Section 4(2) of the Securities Act of 1933, as amended, an exemption for issuer transactions not involving any public offering. The cash proceeds received by the Company from the above transactions were used to fund ongoing operations and working capital requirements.

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

10.63 Technology License Agreement between the registrant and Enmedia, Inc.

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 April 4, 2004, furnishing a press release, dated as of April 1, 2004, announcing the preliminary results for the fourth quarter and year ended December 31, 2003.

The Company filed a Form 8-K on May 11, 2004, regarding a change in the registrants certifying accountants.

The Company filed a Form 8-K on May 18, 2004, furnishing the condensed consolidated balance sheet and statement of operations for the first quarter of 2004.

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: August 16, 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

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