DESWELL INDUSTRIES INC
Form 20FR12B
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
Form 20-F

(Mark One)

o **REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR (g)OF THE SECURITIES EXCHANGE ACT OF 1934**

or

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

For the Fiscal Year Ended March 31, 2008; or

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

For the transition period from__________ to__________; or

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

Date of event requiring this shell company report
For the transition period from__________ to__________ .

Commission File Number: 001-33900

DESWELL INDUSTRIES, INC.
(Exact name of registrant as specified in its charter)
British Virgin Islands
(Jurisdiction of incorporation or organization)
17B, Edificio Comercial Rodrigues
599 Avenida da Praia Grande, Macao
Special Administrative Region, PRC
(Address of principal executive offices)
Betty Lam, Chief Financial Officer, telephone: 853-28-322096, fax: 853-28-323265
17B, Edificio Comercial Rodrigues, 599 Avenida da Praia Grande, Macao
(Name, Telephone, E-mail and/or Facsimile number and Address of Company Contact Person)

Securities registered or to be registered pursuant to Section 12(b) of the Act: Common shares, no par value
Securities registered pursuant to Section 12(g) of the Act: NONE
Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act: NONE
As of March 31, 2008, there were 15,790,810 common shares of the registrant outstanding.

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.
o Yes þ No

If this report is an annual or transition report, indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934. o Yes þ No

Note Checking the box above will not relieve any registrant required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 from their obligations under those Sections.

Indicate by check mark whether the registrant: (i) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (ii) has been subject to such filing requirements for the past 90 days. þ Yes o No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule12b-2 of the Exchange Act. (Check one):

Large accelerated filer o	Accelerated filer þ	Non-accelerated filer o	Smaller reporting company o
		(Do not check if a smaller reporting company)	

Indicate by check mark which basis of accounting the registrant has used to prepare the financial statements included in this filing:

U.S. GAAP þ	International Financial Reporting Standards as issued by the International Accounting Standards Board o	Other o

If Other has been checked, indicate by check mark which financial statement item the registrant has elected to follow:	o Item 17	o Item 18

If this is an annual report, indicate by check mark whether the registrant is a shell company (as defined in Rule12b-2 of the Exchange Act).
o Yes þ No

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INTRODUCTION

This Annual Report on Form 20-F contains forward-looking statements. These statements are subject to certain risks and uncertainties that could cause actual results to differ materially from those anticipated in the forward-looking statements. Factors that might cause such a difference include, but are not limited to those discussed in the section entitled Risk Factors under Item 3. Key Information.

Readers should not place undue reliance on forward-looking statements, which reflect management s view only as of the date of this Report. The Company undertakes no obligation to revise these forward-looking statements to reflect subsequent events or circumstances. Readers should also carefully review the risk factors described in other documents the Company files from time to time with the Securities and Exchange Commission.

Except where the context otherwise requires and for purposes of this Annual Report only:

- we, us, our company, our, the Company or Deswell refers to Deswell Industries, Inc. and, in the conte describing our operations, also include our operating subsidiaries;
- shares refer to our common shares, no par value;
- China or PRC refers to the People s Republic of China, excluding Taiwan, Hong Kong and Macao;
- Hong Kong refers to the Hong Kong Special Administrative Region of the People s Republic of China;
- Macao refers to the Macao Special Administrative Region of the People s Republic of China;
- all references to renminbi, RMB or yuan are to the legal currency of China, of which yuan is the base unit;
- all references to HK dollars or HK$ are to the legal currency of Hong Kong; and
- all references to U.S. dollars, dollars , $ or US$ are to the legal currency of the United States.

FINANCIAL STATEMENTS AND CURRENCY PRESENTATION

The Company prepares its consolidated financial statements in accordance with generally accepted accounting principles in the United States of America and publishes such statements in United States dollars. See Report of Independent Registered Public Accounting Firm included elsewhere herein. The Company publishes its financial statements in United States dollars as the Company is incorporated in the British Virgin Islands, where the currency is the U.S. dollar, and the functional currency of the Company s subsidiaries are Hong Kong dollar and Chinese RMB.

PART I

ITEM 1. IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISORS

Not applicable.

ITEM 2. OFFER STATISTICS AND EXPECTED TIMETABLE

Not applicable.

ITEM 3. KEY INFORMATION

The selected consolidated financial data set forth below should be read in conjunction with our consolidated financial statements and notes thereto included elsewhere in this Report. The selected income statement data for each of the three fiscal years in the period ended March 31, 2008, and the balance sheet data as of March 31, 2007 and 2008 are derived from our audited consolidated financial statements included in this Report. The selected income statement data for the years ended March 31, 2004 and 2005, and the balance sheet data as of March 31, 2004, 2005 and 2006 are derived from our audited consolidated financial statements, which are not included in this Report.

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Selected Financial Data (1)

	(in thousands except per share data) Year ended March 31,				
	2004	2005	2006	2007	2008
Income Statement Data:					
Net sales	$ 97,195	$ 125,590	$ 115,276	$ 136,779	$ 143,806
Cost of sales	66,105	92,072	89,850	105,506	117,373
Gross profit	31,090	33,518	25,426	31,273	26,433
Selling, general and administrative expenses	14,718	15,759	15,052	18,957	19,601
Other income (expenses), net	90	(106)	(823)	1,376	1,838
Operating income (4)	16,462	17,653	9,551	13,692	8,670
Interest expense	(16)	(12)	(6)		
Non-operating income (expenses), net	820	448	447	547	521
Income before income taxes	17,266	18,089	9,992	14,239	9,191
Income taxes	589	576	(27)	1,239	104
Income before minority interests	16,677	17,513	10,019	13,000	9,087
Minority interests	1,957	2,330	1,240	833	228
Net income	$ 14,720	$ 15,183	$ 8,779	$ 12,167	$ 8,859
Basic earnings per share (2)(3)	$ 1.08	$ 1.04	$ 0.59	$ 0.81	$ 0.57
Average number of shares outstanding basic (2)(3)	13,664	14,656	14,908	14,956	15,517
Diluted earnings per share (3)	$ 1.04	$ 1.02	$ 0.59	$ 0.81	$ 0.57
Average number of shares outstanding diluted (2)(3)	14,160	14,933	14,936	15,048	15,556
Statistical Data:					
Gross margin	32.0%	26.7%	22.1%	22.9%	18.4%
Operating margin (4)	16.9%	14.1%	8.3%	10.0%	6.0%
Dividends per share (3)	$ 0.63	$ 0.65	$ 0.63	$ 0.65	$ 0.61

	At March 31,				
	2004	2005	2006	2007	2008
Balance Sheet Data:					
Working capital	$ 52,876	$ 57,576	$ 55,114	$ 58,672	$ 54,751
Total assets	113,534	136,976	130,670	141,210	140,407
Long-term debt, less current portion					
Total debt					
Shareholders equity	89,730	104,767	106,768	111,655	121,257

(1) Our consolidated financial statements are

prepared in accordance with generally accepted accounting principles in the United States of America and are stated in U.S. dollars. See Financial Statements and Currency Presentation.

(2) Basic EPS excludes dilution from potential common shares and is computed by dividing income available to common shareholders by the weighted-average number of common shares outstanding for the period. Diluted EPS reflects the potential dilution from potential common shares.

(3) Share and per share amounts presented above have been adjusted to reflect the three-for-two stock split effected in March 2005 (see Note 12 of Notes to Consolidated Financial Statements).

(4)

Other operating income (expenses) were reclassified in the consolidated statement of income for the year ended March 31, 2007 for a comparable presentation. Comparative figures for the years ended March 31, 2004 to 2006 were reclassified accordingly. The reclassification of operating income has no impact on the net income on the consolidated statement of income the years ended March 31, 2004 to 2006.

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Risk Factors

We may from time to time make written or oral forward-looking statements. Written forward-looking statements may appear in this document and other documents filed with the Securities and Exchange Commission, in press releases, in reports to shareholders, on our website, and other documents. The Private Securities Reform Act of 1995 contains a safe harbor for forward-looking statements on which we rely in making such disclosures. In connection with this safe harbor , we are hereby identifying important factors that could cause actual results to differ materially from those contained in any forward-looking statements made by us or on our behalf. Any such statement is qualified by reference to the following cautionary statements:

We are dependent on a few major customers and have no long-term contracts with them. Our sales would substantially decrease and we would suffer decreases in net income or losses if we lose any of our major customers, if they substantially reduce their orders or if they are unable to pay us.

Historically, a substantial percentage of our sales have been to a small number of customers. Our four largest customers during the year ended March 31, 2008 were Digidesign Inc., Line 6 Manufacturing, Inter-Tel Integrated Systems and N&J Co. Ltd. Each of these customers individually accounted for 10% or more of our total net sales during the year ended March 31, 2008. Customers that individually accounted for ten percent or more of our net sales during the years ended March 31, 2006, 2007 and 2008, accounted for total of 48.3%, 51.5% and 53.3%, respectively, of our total net sales during those years. Our sales are based on purchase orders and we have no long-term contracts with any of our customers and the percentage of sales to any of our customers may fluctuate from time to time. The loss of any one of our largest customers or a substantial reduction in orders from any of them would adversely impact our sales and decrease our net income or cause us to incur losses unless and until we were able to replace the customer or order with one or more of comparable size. In addition, a substantial portion of our sales is made on credit and our results of operations would be adversely affected if a major customer were unable to pay for our products or services.

We have no written agreements with suppliers to obtain components and our profit margins and net income could suffer from an increase in component prices.

We have no written agreements with our component suppliers and for certain customers, we are responsible for purchasing components used in manufacturing their products. This could result in our bearing the risk of component price increases because we may be unable to procure the required materials at a price level necessary to generate anticipated margins. Accordingly, our financial performance could be materially or adversely affected by any increase in component prices.

Our gross margins fluctuate from year to year and may be adversely affected by a number of factors.

The following table sets forth, for the years indicated, our gross margins from our two principal operating segments and for our company as a whole:

	Year ended March 31,		
	2006	2007	2008
Plastic product	11.6%	13.9%	10.5%
Electronic and metallic product	10.5	9.0	7.9
Total	22.1%	22.9%	18.4%

Fluctuations in our margins have been affected, often adversely, and may continue to be affected, by numerous factors, including:

- increasing competition in our market segments, which has forced us to maintain or reduce unit prices or attempt to pass on our costs of materials and components on to customers;

- costs of labor, particularly in recent years, which such costs have increased substantially as consequence of increasing governmental regulation directed at labor practices and policies;

continuing appreciation of the renminbi, in which we pay our labor and manufacturing costs, against the U.S. dollar, in which we present our financial statements;

our cost of raw materials, especially our cost of plastic resins;

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changes in the prices or the availability of components needed to manufacture our electronic products;

changes in our customer mix or the mix of higher and lower margin products, or a combination of both in any year;

increases in value-added taxes as result of changes in the value-added tax policy of the Chinese government for various categories of export products; and

increased costs of conforming our products to consumer and product safety laws and regulations of the various countries in which our products are sold.

We expect gross margins generally and for specific products to continue to fluctuate from year to year. As a result of the above-factors, the confluence of which caused our gross margins to decline substantially in the year ended March 31, 2008 from levels during fiscal 2007, our gross margins may continue to decline. If we cannot stem the decline in our gross margins, our operating results would suffer, dividend payments to shareholders may be decreased or eliminated, our financial position may be harmed and our stock price may fall.

We have no long-term contracts to obtain plastic resins and our profit margins and net income could suffer from an increase in resin prices.

The primary materials used by us in the manufacture of our plastic injection molded products are various plastic resins. The following table shows our cost of plastic resins as a percentage of our cost of plastic products sold and as a percentage of our total costs of goods sold for the years ended March 31, 2006, 2007 and 2008:

	Year ended March 31, 2008		
	2006	2007	2008
Average cost of ABS as a percentage of the total cost of:			
Plastic products sold	53%	52%	46%
Goods sold	21%	20%	17%

We have no long-term contracts with our resin suppliers. Accordingly, our financial performance is dependent to a significant extent on resin markets and the ability to pass through price increases to our customers. The capacity, supply and demand for plastic resins and the petrochemical intermediates from which they are produced are subject to cyclical price fluctuations, including those arising from supply shortages. Consequently, resin prices may fluctuate as a result of changes in natural gas and crude oil prices and the capacity, supply and demand for resin and petrochemical intermediates from which they are produced. We have found that increases in resin prices are difficult to pass on to our customers. In the past increases in resin prices have increased our costs of goods sold and adversely affected our profit margins. A significant increase in resin prices in the future could likewise adversely affect our profit margins and results of operations.

The Chinese government could change its policies toward or even nationalize private enterprise, which could result in the total loss of our investment in that country.

Our manufacturing facilities are located in China. As a result, our operations and assets are subject to significant political, economic, legal and other uncertainties associated with doing business in China. Over the past several years, the Chinese government has pursued economic reform policies including the encouragement of private economic activity and greater economic decentralization. The Chinese government may not continue to pursue these policies or may significantly alter them to our detriment from time to time without notice. Changes in policies by the Chinese government resulting in changes in laws, regulations, or their interpretation, or the imposition of confiscatory taxation, restrictions on currency conversion or imports and sources of supply could materially and adversely affect us. The nationalization or other expropriation of private enterprises by the Chinese government could result in the total loss of our investment in that country.

There may be a lack of remedies and impartiality under the Chinese legal system that prevents us from enforcing the agreements under which we operate our factories.

We do not own the land on which our factories in China are located. We occupy our manufacturing facilities under land use agreements or under tenancy agreements with the local Chinese government. These agreements may be difficult to enforce in China, which could force us to accept terms that may not be as favorable as those provided in our agreements. Unlike the U.S., China has a civil law system based on written statutes in which judicial decisions have little precedential value. The Chinese government has enacted some laws and

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regulations dealing with matters such as corporate organization and governance, foreign investment, commerce, taxation and trade. However, their experience in implementing, interpreting and enforcing these laws and regulations is limited, and our ability to enforce commercial claims or to resolve commercial disputes is unpredictable. These matters may be subject to the exercise of considerable discretion by agencies of the Chinese government, and forces unrelated to the legal merits of a particular matter or dispute may influence their determination.

If our business licenses in China were not renewed, we would be required to move our operations out of China, which would impair our profitability, competitiveness and market position and jeopardize our ability to continue operations.

Our activities in China require business licenses. This requires a review and approval of our activities by various national and local agencies of Chinese government. The Chinese government may not continue to approve our activities or grant or renew our licenses. Our inability to obtain needed approvals or licenses could prevent us from continuing to conduct operations in China. If for any reason we were required to move our manufacturing operations outside of China, our profitability would be substantially impaired, our competitiveness and market position would be materially jeopardized and we may not be able to continue operations.

Our insurance coverage may not be adequate to cover loss related to major accidents or acts of God.

Firefighting and disaster relief or assistance in China are primitive by Western standards. At March 31, 2008, we maintained fire, casualty and theft insurance aggregating approximately $126,846,000 covering certain of our stock in trade, goods and merchandise, furniture and equipment and factory buildings in China. The proceeds of this insurance may not be sufficient to cover material damage to, or the loss of, any of our factories due to fire, severe weather, flood, act of God in the future, such as the recent earthquake that has devastated areas in Sichuan province in China, the epicenter of which is about 800 to 900 miles from Dongguan, China, or other cause. We do not maintain any business interruption insurance.

We may be faced with product liability claims.

Despite quality assurance measures, there remains a risk that defects may occur in our products. The occurrence of any defects in our products could give rise to liability for damages caused by such defects. They could, moreover, impair the market s acceptance of our products. Both could have a material adverse effect on our business and financial condition. At March 31, 2008, we maintained product liability insurance aggregating approximately $4,500,000. Although we believe such coverage is adequate based on the historical rate and nature of customer product quality claims or complaints, we cannot assure investors that this insurance would adequately cover our costs arising from any significant defects in our products.

Possible changes and uncertainties in economic policies in the Special Economic Zones of China in which we operate could harm our operations by eliminating benefits we currently enjoy.

As part of its economic reform, China has designated certain areas, including Shenzhen where we have certain manufacturing facilities, as Special Economic Zones. Foreign enterprises in these areas benefit from greater economic autonomy and more favorable tax treatment than enterprises in other parts of China. Changes in the policies or laws governing Special Economic Zones could eliminate these benefits. Moreover, economic reforms and growth in China have been more successful in certain provinces than others, and the continuation or increase of these disparities could affect the political or social stability of China.

Changes to PRC tax laws and heightened efforts by the China s tax authorities to increase revenues are expected to subject us to greater taxes.

Under prior PRC law, we were afforded a number of tax concessions by, and tax refunds from, China s tax authorities on a substantial portion of our operations in China by reinvesting all or part of the profits attributable to our PRC manufacturing operations. . However, on March 16, 2007, the Chinese government enacted a new unified enterprise income tax law which became effective on January 1, 2008. Prior to this new income tax law, as a foreign invested enterprise located in Dongguan, PRC, our PRC subsidiaries have enjoyed preferential tax as high tech enterprise or export-oriented enterprise at the range of 10% to 15% and 3% local income tax. Under the new income tax law most domestic enterprises and foreign invested enterprises, like Deswell, would be subject to a single PRC enterprise income tax rate and gradually transfer to the new tax rate of 25% within five years. For information on the new enterprise income tax, (EIT) rates as announced by the PRC s State Council, please see the table in Item 5.

Operating and Financial Review and Prospects. The preferential tax treatment to our subsidiaries in the PRC of qualifying for tax refunds as a result of reinvesting their profits earned in previous years in the PRC also expired on

January 1, 2008. Therefore, the impact of this increase on our overall tax rate will depend on, among other things, our income from our PRC subsidiaries, the actual implementation of the terms of transition under the EIT by the PRC government and our ability to qualify our existing operations as high-tech enterprises under the new law.

Payment of dividends by our subsidiaries in the PRC to us is subject to restrictions under PRC law. The new PRC tax law could force us to reduce the amount of dividends we have historically paid to our shareholders or possibly eliminate them or we may decide not pay dividends in the future.

Under PRC law, dividends may be paid only out of distributable profits. Distributable profits with respect to our subsidiaries in the PRC refers to after-tax profits as determined in accordance with accounting principles and financial regulations applicable to PRC enterprises (China GAAP) less any recovery of accumulated losses and allocations to statutory funds that it is required to make. Any distributable profits that are not distributed in a given year are retained and available for distribution in subsequent years. The calculation of distributable profits under China GAAP differs in many respects from the calculation under U.S. GAAP. As a result, our subsidiaries in PRC may not be able to pay any dividend in a given year as determined under U.S. GAAP. The China s tax authorities may require changes in determining income of the Company that would limit its ability to pay dividends and make other distributions. PRC law requires companies, including our PRC subsidiaries, to reserve about 11% of their profits for future development and staff welfare, which amounts are not distributable as dividends. These rules and possible changes to them could restrict our PRC subsidiaries from repatriating funds ultimately to us and our stockholders as dividends.

Prior to the new EIT law, PRC-organized companies were exempt from withholding taxes with respect to earnings distributions, or dividends, paid to shareholders of PRC companies outside the PRC, such as was the case when our PRC subsidiaries distributed portions of their earnings to our offshore subsidiaries. However, under the new EIT Law, dividends payable to foreign investors which are derived from sources within the PRC will be subject to income tax at the rate of 10% by way of withholding unless the foreign investors are companies incorporated in countries which have a tax treaty agreement with PRC and rate agreed by both parties will be applied. As a result of this new PRC withholding tax, amounts available to us in earnings distributions from our PRC enterprises will be reduced. Since we derive most of our profits from our subsidiaries in PRC, the reduction in amounts available for distribution from our PRC enterprises could, depending on the income generated by our PRC subsidiaries, force us to reduce, or possibly eliminate, the dividends we have paid to our shareholders historically. For this reason, or other factors, we may decide not to declare dividends in the future. If we do pay dividends, we will determine the amounts when they are declared and even if we do declare dividends in the future, we may not continue them in any future period.

We could suffer losses from corrupt or fraudulent business practices. Conducting business in China is inherently risky.

Corruption, extortion, bribery, pay-offs, theft, and other fraudulent practices are common in China. For example, in the six months ended September 30, 2005, we recorded a provision of approximately $1 million for doubtful sales transactions, consisting of orders primarily from three customers for products of the metallic parts division of our electronic & metallic parts business segment that had been shown as shipped to, and received by, the customers but in fact had been surreptitiously cancelled without shipment. Documentation reflecting the cancellation of the orders was uncovered following the departure of the General Manager of the Company s metallic parts division who, with the assistance of a Production and Materials Control Supervisor in that division (who since left Deswell), had previously concealed such documentation. We could suffer additional losses from similar or other fraudulent practices if we are not successful in implementing and maintaining preventative measures.

Controversies affecting China s trade with the United States could harm our operations or depress our stock price.

While China has been granted permanent most favored nation trade status in the United States, controversies between the United States and China may arise that threaten the status quo involving trade between the United States and China. These controversies could adversely affect our business by, among other things, causing our products in the United States to become more expensive, which could result in a reduction in the demand for our products by customers in the United States. Political or trade friction between the United States and China, whether or not actually affecting our business, could also adversely affect the prevailing market price of our common shares. This risk has increased in recent years as our sales into the United States have accounted for increasing amounts of

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our global sales, culminating with our year ended March 31, 2007, when, for the first time, the United States became the largest geographic market for our products.

Changes in currency rates involving the Hong Kong dollar could increase our expenses or cause economic or political problems affecting our business. Changes in currency rates involving the RMB implemented in July 2005 have increased our expenses since they were implemented.

Our sales are mainly in United States dollars and Hong Kong dollars and our expenses are mainly in United States dollars, Hong Kong dollars and Chinese RMB. The Chinese government may not continue to maintain the present currency exchange mechanism, which fixes the Hong Kong dollar at approximately the range of 7.78 to 7.80 to each United States dollar and has not in the past presented a currency exchange risk. This could change in the future if those in Hong Kong arguing for a floating currency system prevail in the ongoing debate over whether to continue to peg the Hong Kong dollars to the U.S. dollars. For approximately three years prior to July 2005, the exchange rate between the Chinese currency, the renminbi, and the U.S. dollars varied by less than one-tenth of one percent. However, on July 21, 2005, the People s Bank of China adjusted the exchange rate of U.S. dollars to RMB from 1:8.27 to 1:8.11, resulting in an approximately 2.4% appreciation in the value of the RMB against the U.S. dollar. As a result, and in addition to increases in our plastic resin and labor costs, our operating costs increased from levels in 2006 and 2007. Since we were not able to pass most of these cost increases on to our customers by increasing sales prices of our products, our gross margins, operating income and net income were adversely affected in each of the last three fiscal years. If the Chinese government allows a further and significant RMB appreciation, and there are indications that the Chinese government has accelerated the RMB s appreciation to the dollar with it reaching 1:6.823 on July 25, 2008, our operating costs could further increase and could further adversely affect our financial results.

Any future outbreak of severe acute respiratory syndrome or other diseases may have a negative impact on our business and operating results.

In the first calendar quarter of 2003, several economies in Asia, including Hong Kong, where our logistic support office and some of our customers are located, and southern China, where our factories are located, were affected by the outbreak of severe acute respiratory syndrome, or SARS. If there is a recurrence of an outbreak of SARS, it may adversely affect our business and operating results. For example, a future SARS outbreak could result in quarantines or closure to our office in Hong Kong or factories in China if our employees are infected with SARS and ongoing concerns regarding SARS, particularly its effect on travel, could negatively impact our customers and suppliers based in Hong Kong or China and our business and operating results.

In addition, there has recently been an outbreak of avian influenza in humans in Asian countries, including Vietnam, South Korea and Japan, which has proven fatal in some instances. Many are concerned that the virus will mutate and trigger a human pandemic. Additionally, there have been recent reports of a virus called enterovirus-71 that has broken out in China (including the Southern Region of Guangdong province, where our factories are located), Hong Kong, Taiwan, Singapore and Vietnam, which in China has killed several children and sickened more than 4,000. If an outbreak of avian influenza were to spread to southern China or if enterovirus-71 or mutations were to spread and begin infecting adults, our business and operating results could be adversely affected.

Political and economic instability of Hong Kong and Macao could harm our operations.

Our administration and accounting office are located in Macao, formerly a Portuguese Colony and some of our customers and suppliers are located in Hong Kong, formerly a British Crown Colony. Sovereignty over Macao and Hong Kong was transferred to China effective on December 20, 1999 and July 1, 1997, respectively. Since their transfers, Macao and Hong Kong have become Special Administrative Regions of China, enjoying a high degree of autonomy except for foreign and defense affairs. Moreover, China s political system and policies are not practiced in Macao or Hong Kong. Under the principle of one country, two systems, Macao and Hong Kong maintain legal systems that are different from that of China. Macao s legal system is based on the Basic Law of the Macao Special Administrative Region and, similarly, Hong Kong s legal system is based on the Basic Law of the Hong Kong Special Administrative Region. It is generally acknowledged as an open question whether Hong Kong s future prosperity in its role as a hub and gateway to China after China s accession to the World Trade Organization (introducing market liberalization in China) will be diminished. The continued stability of political, economic or commercial conditions in Macao and Hong Kong remain uncertain, and any instability could have an adverse impact on our business.

Labor shortages in Southern China have adversely affected our gross margins and will likely continue to do so in the future.

We conduct all of our manufacturing operations in Southern China, specifically in Guangdong province, where we were able to take advantage of the lower overhead costs and inexpensive labor rates as compared to Hong Kong. Historically, there has been an abundance of labor in Southern China, but since 2002, intensifying in 2004 and continuing to worsen since then, factories in Southern China have been facing a labor shortages as migrant workers engaged in production (typically young women and men who come from various rural provinces in the PRC for the purpose of working for wages higher than are available in such rural regions), technical workers and middle level management seek better wages and working conditions in other provinces of China. A recent survey conducted by Guangdong labor authorities predicts that the labor shortage in Guangdong will worsen in 2008 as demand for technically skilled workers rises by 20% and the number of ordinary workers needed rises by 10%. Past efforts by Guangdong authorities seeking to arrest the labor shortages by removing the ban on hiring new migrant laborers in the month after the Lunar New Year holiday and raising the minimum wage do not appear to have been successful at luring workers back to Southern China and such changes to the minimum wage have adversely impacted our gross margins. This trend of labor shortages is expected to continue, fueled by the effects of the one-child policy imposed by the Chinese government over the past three decades and will likely result in increasing wages as companies seek to keep their existing work forces. Continuing labor shortages can be expected to adversely impact our future operating results by, for example, preventing us from manufacturing at peak capacity and forcing us to increase wages and benefits to attract the diminishing pool of available workers. This would result in lower revenues and increased manufacturing costs, which would adversely affect gross margins.

Recent changes in the PRC s labor law restrict our ability to reduce its workforce in the event of an economic downturn.

In June 2007, the National People s Congress of the PRC enacted new labor law legislation called the Labor Contract Law, which became effective on January 1, 2008. It formalizes workers rights concerning overtime hours, pensions, layoffs, employment contracts and the role of trade unions. Considered one of the strictest labor laws in the world, among other things, this new law requires an employer to conclude an open-ended employment contract with any employee who either has worked for the employer for 10 years or more or has had two consecutive fixed-term contracts. An open-ended employment contract is in effect a lifetime, permanent contract, which is terminable only in specified circumstances, such as a material breach of the employer s rules and regulations, or for a serious dereliction of duty. Such employment contracts with qualifying workers would not be terminable if, for example, Deswell determined to downsize its workforce in the event of an economic downturn. Under the new law, downsizing by 20% or more may occur only under specified circumstances, such as a restructuring undertaken pursuant China s Enterprise Bankruptcy Law, or where a company suffers serious difficulties in production and/or business operations. Deswell s entire staff, who are employed to work exclusively within the PRC, is covered by the new law and thus, Deswell s ability to adjust the size of its operations when necessary in periods of recession or less severe economic downturns has been curtailed. Accordingly, if Deswell faces future periods of decline in business activity generally or adverse economic periods specific to Deswell s business, this new law can be expected to exacerbate the adverse effect of the economic environment on Deswell s results of operations and financial condition.

Our customers are dependent on shipping companies for delivery of our products and interruptions to shipping could materially and adversely affect our business and operating results.

Generally, we sell our products F.O.B. Hong Kong or F.O.B. China and our customers are responsible for the transportation of products from Hong Kong or China to their final destinations. Our customers rely on a variety of carriers for product transportation through various world ports. A work stoppage, strike or shutdown of one or more major ports or airports could result in shipping delays materially and adversely affecting our customers, which in turn could have a material adverse effect on our business and operating results. Similarly, an increase in freight surcharges due to rising fuel costs or general price increases could materially and adversely affect our business and operating results.

Protecting, seeking licenses for or asserting claims over, intellectual property could be costly.

We usually rely on trade secrets, industry expertise and the sharing with us by our customers of their intellectual property. However, there can be no assurance that intellectual property that we use in our business does not violate rights in such property belonging to others. We may be notified that we are infringing patents, copyright or other intellectual property rights owned by other parties. In the event of an infringement claim, we may be required to spend a significant amount of money to develop a non-infringing alternative or to obtain licenses. We may not be successful in developing alternatives or in obtaining licenses on reasonable terms, if at all. Any litigation, even without merit, could result in substantial costs and could adversely affect our business and operating results.

Our strategy has been to evaluate trade names and trademarks, and to consider seeking patents, where we believe that such trade names, trademarks or patents would be available and adequate to protect our rights to products or processes that we consider material to our business. To the extent we do seek to obtain trade names, trademarks or patents, we may be required to institute litigation in order to enforce them or other intellectual property rights to protect our business interests. Such litigation could result in substantial costs and could adversely affect sales, profitability and growth.

Because our operations are international, we are subject to significant worldwide political, economic, legal and other uncertainties.

We are incorporated in the British Virgin Islands and have subsidiaries incorporated in the British Virgin Islands, Hong Kong, Macao, Samoa and China. Our administrative and accounting office is located in Macao. We manufacture all of our products in China. As of March 31, 2008, approximately 73% of the net book value of our total identifiable fixed assets was located in China. We sell our products to customers principally in the United States, China, United Kingdom, Hong Kong, Europe and Southeast Asia. Our international operations may be subject to significant political and economic risks and legal uncertainties, including:

- changes in economic and political conditions and in governmental policies,
- changes in international and domestic customs regulations,
- wars, civil unrest, acts of terrorism and other conflicts,
- changes in tariffs, trade restrictions, trade agreements and taxation,
- difficulties in managing or overseeing foreign operations, and
- limitations on the repatriation of funds because of foreign exchange controls.

The occurrence or consequences of any of these factors may restrict our ability to operate in the affected region and decrease the profitability of our operations in that region.

Our loss of certain members of our senior management could cause disruptions in our business and harm our customer relationships thereby adversely affecting sales.

We depend to a large extent on the abilities and continued participation of

- Richard Lau, our former Chief Executive Officer, who retired from this post in January 2007, and remains Chairman of our Board of Directors;
- Franki S.F. Tse, our Chief Executive Officer, who in February 2007 succeeded Richard Lau;
- C. P. Li, our Executive Director of Manufacturing and Administration for plastic products;
- C. W. Leung, Executive Director of Engineering for Plastic Operations;
- S. K. Lee, our Director of Administration and Marketing for Electronic Operations; and
- M. C. Tam, our Director of Engineering and Manufacturing for Electronic Operations.

Mr. Richard Lau, who retired as our Chief Executive Officer in February 2007, and Messrs. Li and Leung founded our company and have each played integral roles in the management, growth and development of our company in general and our plastic injection molding business in particular. They have developed and maintain relationships with several of our key customers in our plastic injection molding business. Mr. S. K. Lee and Mr. M. C. Tam founded our electronic products manufacturing business and have developed and continue to manage it since we acquired control of the business from them. We have no employment contracts with Messrs. Li, Leung, Lee and Tam and their loss would require us to find executives suitable to replace them, which could be difficult and disruptive to our business. Customers with whom they have relationships may cease to deal with us or choose to use a competitor for a greater portion of their business, resulting in our loss of sales.

Compliance with current and future environmental regulations may be costly which could impact our future earnings. Our results could be adversely affected if we have to comply with new environmental regulations.

Our operations create some environmentally sensitive waste that may increase in the future depending on the nature of our manufacturing operations. The general issue of the disposal of hazardous waste has received increasing attention from Chinese national and local governments and foreign governments and agencies and has been subject to increasing regulation. Currently, relevant Chinese environmental protection laws and regulations impose fines on discharge of waste materials and empower certain environmental authorities to close any facility which causes serious environmental problems. Although it has not been alleged that we have violated any current environmental regulations by China government officials, the Chinese government could amend its current environmental protection laws and regulations. Our business and operating results could be materially and adversely affected if we were to increase expenditures to comply with environmental regulations affecting our operations.

In addition, we could face significant costs and liabilities in connection with product take-back legislation, which enables customers to return a product at the end of its useful life and charge us with financial and other responsibility for environmentally safe collection, recycling, treatment and disposal. We also face increasing complexity in our product design and procurement operations as we adjust to new and upcoming requirements relating to the materials composition of our electronic products, including the restrictions on lead and certain other substances in electronics that apply to specified electronics products put on the market in the European Union as of July 1, 2006 (Restriction of Hazardous Substances in Electrical and Electronic Equipment Directive (RoHS). The labeling provisions of similar legislation in China went into effect on March 1, 2007. Consequently, many suppliers of products sold into the EU countries have required their suppliers to be compliant with the new directive. Many of these customers in our electronic division have adopted this approach and have required our full compliance. Though we have devoted a significant amount of resources and effort planning and executing our RoHS program, it is possible that some of our products might be incompatible with such regulations. In such event, we could experience the loss of revenue, damaged reputation, diversion of resources, monetary penalties, and legal action. Other environmental regulations may require us to reengineer our products to utilize components that are more environmentally compatible. Such reengineering and component substitution may result in additional costs to us. Although we currently do not anticipate any material adverse effects based on the nature of our operations and the effect of such laws, there is no assurance that such existing laws or future laws will not have a material adverse effect on us. Power shortages in China could affect our business.

We consume substantial amounts of electricity in our manufacturing processes at our production facilities in China. Certain parts of China, including areas where our manufacturing facilities are located, have been subject to power shortages in recent years. We have experienced a number of power shortages at our production facilities in China to date. We are sometimes given advance notice of power shortages and in relation to this we currently have a backup power system. However, there can be no assurance that in the future our backup power system will be completely effective in the event of a power shortage, particularly if that power shortage is over a sustained period of time and/or we are not given advance notice of it. Any power shortage, brownout or blackout for a significant period of time may disrupt our manufacturing, and as a result, may have an adverse impact on our business.

The concentration of share ownership in our Chairman of the Board and members of senior management may allow them to control, and influence substantially, the outcome of matters requiring shareholder approval if such individuals acted together.

Our Chairman of the Board, Richard Lau, and members of our senior management consisting of C. P. Li and C. W. Leung, each of whom are also members of our board of directors, beneficially own an aggregate of approximately 28% of our shares at June 30, 2008. As a result, acting together, they may be able to control, and they can substantially influence, the outcome of all matters requiring approval by our shareholders, including the election of directors and approval of significant corporate transactions. This ability may have the effect of delaying or preventing a change in control of Deswell, or causing a change in control of Deswell that may not be favored by our other shareholders.

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In the course of preparing our consolidated financial statements for the fiscal year ended March 31, 2008, a material weakness in our internal controls over financial reporting was identified. If we fail to implement, achieve and maintain an effective system of internal controls, and as a result of this material weakness or others that may be identified, we may be unable to accurately report our financial results, and investor confidence and the market price of our shares may be adversely impacted.

We became subject to Section 404 of the Sarbanes-Oxley Act of 2002 in the fiscal year ended March 31, 2007, which required us to include a management report containing an assessment of our internal controls over financial reporting in our Annual Report. Beginning with the fiscal year ended March 31, 2008, we are also required to include an attestation and report on the effectiveness of our internal controls over financial reporting of our independent registered public accounting firm. In preparing our consolidated financial statements for our fiscal year ended March 31, 2008, a material weakness in our internal control over financial reporting was identified, as defined in the standards established by the U.S. Public Company Accounting Oversight Board. A material weakness is defined as a significant deficiency or combination of significant deficiencies that result or results in more than a remote likelihood that a material misstatement of a company s financial statements will not be prevented or detected. The material weakness identified related to the process we used to determine the valuation of work in progress and finished goods inventories in our plastic manufacturing operations.

Because of the material weakness, management has concluded that, as of March 31, 2008, our internal controls over financial reporting were not effective. This failure and any failure in the future to achieve and maintain effective internal controls over financial reporting and otherwise comply with the requirements of Section 404 could have a material adverse effect on our business. Such noncompliance could result in perceptions of our business among customers, suppliers, lenders, investors, securities analysts and others being adversely affected. Our remediation plan, consisting of the redesign of the process we are using may not adequately address the identified material weakness in our internal controls over financial reporting and we may not be able to attract additional qualified financial, auditing and compliance personnel to assist us in implementing the remediation plan effectively and maintaining compliance programs. If our remediation plan is inadequate to remediate the identified material weakness in our internal controls over financial reporting, our future financial statements could contain errors that may be undetected. For additional information, please see Item 15. Controls and Procedures in this Report.

Potential new accounting pronouncements are likely to impact our future financial position and results of operations and in the case of FASB s pronouncement regarding the expensing of stock options have adversely impacted, and will in the future, adversely impact our financial results.

Deswell prepares its financial statements in conformity with the generally accepted accounting principles of the United States of America US GAAP . A change in these accounting principles and policies, especially as interpreted by the Securities and Exchange Commission and Nasdaq Stock Market, may have an impact on our future financial position and results of operations. These regulatory changes and other legislative initiatives have increased general and administrative costs. The Financial Accounting Standards Board s recent change to mandate the expensing of stock options require us to record charges to earnings for stock option grants to employees and directors have adversely affected our financial results. As required, we implemented the new pronouncement effective on April 1, 2006 and the impact of that implementation has been reflected in our financial results beginning with for the first quarter of 2007, i.e., the quarter ended June 30, 2006

Our board s ability to amend our charter without shareholder approval could have anti-takeover effects that could prevent a change in control.

As permitted by the law of the British Virgin Islands, our Memorandum and Articles of Association, which are the terms used in the British Virgin Islands for a corporation s charter and bylaws, may be amended by our board of directors without shareholder approval provided that a majority of our independent directors do not vote against the amendment. This includes amendments to increase or reduce our authorized capital stock or to create from time to time and issue one or more classes of preference shares (which are analogous to preferred stock of corporations organized in the United States). Our board s ability to amend our charter documents without shareholder approval, including its ability to create and issue preference shares, could have the effect of delaying, deterring or preventing a change in control of Deswell, including a tender offer to purchase our common shares at a premium over the then current market price.

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Our exemptions from certain of the reporting requirements under the Exchange Act limits the protections and information afforded to investors.

We are a foreign private issuer within the meaning of rules promulgated under the Securities Exchange Act of 1934. As a foreign private issuer, we are exempt or excluded from certain provisions applicable to United States public companies including:

- the rules under the Exchange Act requiring the filing with the Commission of quarterly reports on Form 10-Q or current reports on Form 8-K;
- the sections of the Exchange Act regulating the solicitation of proxies, consents or authorizations in respect to a security registered under the Exchange Act;
- the sections of the Exchange Act requiring insiders to file public reports of their stock ownership and trading activities and establishing insider liability for profits realized from any short-swing trading transaction (i.e., a purchase and sale, or sale and purchase, of the issuer s equity securities within less than six months); and
- Regulation FD, the SEC s rules regulating disclosure of information by publicly traded companies and other issuers and requiring that when an issuer discloses material nonpublic information to certain individuals or entities such as stock analysts, or holders of the issuer s securities who may trade on the basis of the information, the issuer must make public disclosure of that information.

In addition, because we are a foreign private issuer, certain of the corporate governance standards of The Nasdaq Stock Market that are applied to domestic companies having securities included on The Nasdaq Stock Market are not applicable to us. For example, as a foreign private issuer organized under the law of the British Virgin Islands, we may follow our home company practice in lieu of some of the provisions of NASDAQ s Marketplace Rule 4350. Accordingly, as the law of the British Virgin Islands does not prohibit us from doing so and since our practices are in compliance with our Memorandum and Articles of Association, we follow our home company practices with respect to the following Nasdaq Market Place rules:

- *Rule 4350(c)(1):* A majority of our Board of Directors are not independent directors within the definition of independent director in Nasdaq Marketplace Rule 4200(a)(15);
- *Rule 4350(c)(2)*: Our independent directors do not meet in executive session;
- *Rule 4350(c)(3)*: Our board does not have a compensation committee;
- *Rule 4350(c)(4)*: Nominees for appointment as our directors are not selected or recommended by (i) a majority of our independent directors, or a nominating committee composed solely of independent directors.

Because of these exemptions or exclusions, investors are not afforded the same protections or information generally available to investors in public companies organized in the United States or with securities included on The NASDAQ Stock Market.

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ITEM 4. INFORMATION ON THE COMPANY

History and Development of Deswell

Corporate Information

Deswell Industries Inc., was founded in 1987 in Hong Kong and moved its manufacturing operations to China in 1990 to take advantage of lower overhead cost, competitive labor rate and tax concessions available in Shenzhen, China as compared with Hong Kong. We were reincorporated in December 1993 as a limited liability International Business Company under the laws of the British Virgin Islands. The Company s registered agent in the British Virgin Islands is HWR Services Limited, P.O. Box 71, Craigmuir Chambers, Road Town, Tortola, British Virgin Islands. The Company s principal administrative office is located in 17B, Edificio Comercial Rodrigues, 599 Avenida da Praia Grande, Macao, and its telephone number is (853) 28322096 and its facsimile number is (853) 28323265. Our principal manufacturing facilities and operations are currently based in Dongguan, Guangdong, China.

Important Events in Deswell s Development that Have Occurred since April 1, 2007

In August 2007, Deswell acquired the remaining 24% minority interest of Integrated International Limited (Integrated), the holding company for Deswell s electronics and metallic subsidiaries. The aggregate purchase price for the 24% interest was $6,734,378, consisting of (a) 632,080 common shares of Deswell (based on the closing price per share of Deswell s shares on August 17, 2008) and (b) a cash payment of HK$3,234,180 (approximately US$413,578), which Deswell paid to Messrs. S. K. Lee and M. C. Tam, the minority shareholders of Integrated and Deswell s Director of Administration and Marketing for Electronic Operations,, our Director of Engineering and Manufacturing for Electronic Operations, respectively, and executive officers of Deswell. Messrs. Lee and Tam agreed with respect to the shares issued to them by Deswell that for a period of 15 months from the closing of this transaction not to offer to sell, contract to sell, or otherwise sell, dispose of, loan, pledge or grant any rights with respect to any of the Deswell shares they acquired for their Integrated interest or grant any options or warrants to purchase any of those shares or any securities convertible into or exchangeable for those shares otherwise than as a bona fide gift or gifts, provided the donee or donees thereof agree in writing to be bound by the lockup restriction, or (ii) with the prior written consent of Deswell. The lockup period expires in November 2008.

In April 2008, we received formal notice from the Companies Commission of Malaysia that, in accordance with the application we had filed in June 2006, our subsidiary Jetcrown Industrial Sdn. Bhd., a limited liability Malaysian Company we established in June 2000, had been stricken off from the Malaysian Companies Registry and thereby dissolved.

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Organizational Structure

The following diagram illustrates the organizational structure of the Company and its active subsidiaries at March 31, 2008.

Capital Expenditures

Principal capital expenditures and divestitures made by Deswell during the three years in the period ended March 31, 2008 include the following:

	Year ended March 31,		
	2006	2007	2008
Purchase of property, plant and equipment	$6,940,000	$7,812,000	$7,288,000
Proceeds from the sale of property, plant and equipment	50,000	3,232,000	333,000
Acquisition of minority interest in a subsidiary			414,000

Principal capital expenditures made and currently in progress relate to improvements we are constructing and have constructed on the land we purchased in Dongguan, China to build a new factory. The construction of our new Dongguan factory and dormitories is planned to occur in three to four phases. The pace of construction depends on our financial situation and future operating results.

Through March 31, 2007, Deswell spent an aggregate of approximately $8.0 million on the first phase of construction of its new plastic injection molding plant. The facility comprises approximately 466,000 square feet of factory space, an approximately 91,000 square foot amenity center and approximately 116,000 square feet of dormitory space. Construction began in October 2001 and was completed in March 2003 with the interior build-out finished in June 2003. After installation of machinery and final touch up, Phase I of the new factory became operational at the end of November 2003. During the same period, approximately $19.9 million were used to expand the Company s injection molding and tool-making capacity through the purchase of additional injection molding and tooling machinery and $7.4 million were used to acquire and install furniture and fixtures for operations.

Following completion of space built through Phase I, we spent an aggregate of approximately $7.3 million for the second phase of construction, which comprises two additional factory building units covering approximately 227,000 square feet and three additional dormitory units of approximately 216,000 square feet. During the same period, we spent approximately $4.7 million to expand our injection molding and tool-making capacity through the purchase of additional injection molding and tooling machinery and spent approximately $2.1 million to acquire and install furniture and fixtures for operations.

Phase III of construction, with a planned investment of $10 million, of which we spent an aggregate of $6.9 million through March 31, 2008, will consist of an estimated 133,000 square foot office building, an estimated 377,000 square feet of additional factory space and one additional dormitory unit of approximately 120,000 square feet. During the same period, we spent approximately $1.6 million to acquire and install furniture and fixtures for operation.

Phase IV of construction, to consist of planned additional two dormitory units and two other buildings, is planned for the long-term and will be commenced as further capacity is needed.

All of the foregoing capital expenditures were financed principally from internally generated funds and our current plan is to continue to use internally generated funds principally to finance future capital expenditures. However, we may choose to obtain debt or equity financing if we believe it appropriate to accelerate the phases of construction of our facilities.

Business Overview

We are an independent manufacturer of injection-molded plastic parts and components, electronic products and subassemblies and metallic molds and accessory parts for original equipment manufacturers, or OEMs and contract manufacturers. We conduct all of our manufacturing activities at separate plastics, electronics and metallic operation factories located in the People s Republic of China. Beginning in January 2005, we also began to engage in the business of distributing audio equipment in China.

We produce a wide variety of plastic parts and components that are used in the manufacture of consumer and industrial products, using different plastic injection technologies, such as film injection, integrated injection and insert injection. The products include:

cases and key tops for personal organizers and remote controls;

cases for flashlights, telephones, paging machines, projectors and alarm clocks;

grips and rods for fishing tackle;

toner cartridges and cases for photocopy and printer machines;

parts for electrical products such as air-conditioning and ventilators;

parts for audio equipment;

double injection caps and baby products;

laser key caps; and

automobile components.

Electronic products manufactured by the Company include

complex printed circuit board assemblies using surface mount (SMT), ball grip assembly (BGA) and pin-through-hole (PTH) interconnection technologies and

finished products which include business communication products such as digital phone systems, or digital keysets and voice over IP, or VoIP, phones, and

sophisticated professional audio equipment including digital audio workstation, digital or analogue mixing consoles, instrument amplifiers, signal processors, firewire/USB audio interfaces, keyboard controllers and synthesizers, etc.

Metal products manufactured by the Company include metallic molds and accessory parts used in audio equipment, telephones, copying machines, pay telephones, multimedia stations, automatic teller machines, vending machines, etc.

As part of its manufacturing operations, the Company consults with its customers in the design of plastic parts and the design and production of the molds used to manufacture plastic parts, which are made by Deswell at its customers expense, and provides advice and assistance in the design and manufacturing of printed circuit boards. The Company believes that its ability to manufacture high-end plastic and metal parts of the quality required by OEMs and contract manufacturers which furnish products and services internationally, Deswell s expertise in designing and manufacturing molds for its customers and the Company s low production costs distinguish Deswell from most other manufacturers of plastic products and provide it with a competitive advantage. However, this advantage has been difficult to maintain as a result of increased competition and increased production overheads during the years ended March 31, 2006, 2007 and 2008.

Industry Overview

Management believes that the injection molding and metal molds and parts manufacturing industries have each benefited in recent years from a trend among major users of injection molded and metal products to outsource an increasing portion of the parts requirements and to select a small number of suppliers or a sole supplier to provide those products. The Company is not aware of any empirical data defining the manufacturing industry in China, however, management believes that injection molding and metal manufacturing firms which are much smaller than the Company make up the largest segment of the industry in China. The Company s experience indicates that such smaller firms are often unable to react quickly and responsively to the diverse demands of many customers and are not capable of furnishing the level of quality that high-end plastic and metal products require. Management believes that this inability on the part of these smaller manufacturers has created opportunities for the Company to increase sales by catering to the outsourcing requirements of OEMs and contract manufacturers that manufacture such high-end products.

Similarly, as a result of the recognition by OEMs in the electronics industry of the rising costs of operating a manufacturing site and the need to add more sophisticated and expensive manufacturing processes and equipment, OEMs have turned increasingly to outside contract manufacturers. By doing so, OEMs are able to focus on research, product conception, design and development, marketing and distribution, and to rely on the production expertise of contract manufacturers. Other benefits to OEMs of using contract manufacturing include: access to manufacturers in regions with low labor and overhead costs, reduced time to market, reduced capital investment, improved inventory management, improved purchasing power and improved product quality. In addition, the use of contract manufacturers has helped OEMs manage production in view of increasingly shorter product life cycles.

Operations

Plastic Injection Molding

Plastic injection molding manufacturing accounted for 41.9%, 43.5% and 40.9% of the Company s total sales during the years ended March 31, 2006, 2007 and 2008, respectively. At March 31, 2008, the Company conducted its plastic manufacturing operations in approximately 1,070,000 square feet of factory space in its factory located in Dongguan, Guangzhou, China. The factory space of approximately 113,000 square feet located in Shekou, Shenzhen, China, which Deswell formerly used for contract manufacturing, was being used for clerical and offices operations at March 31, 2008 and Deswell currently intends to sell its land lease on this property.

The Company s plastic injection molding process consists of three phases: (1) mold design and production; (2) plastic injection; and (3) finishing.

Mold design and production.

The plastic injection-molding process begins when a customer provides the Company with specifications for a product or part, which specifications are often created in consultation with the Company s technical staff. Next the Company designs and produces the mold, using great care in the design process and in the selection of materials to produce the mold in an effort to create a high quality appearance of the completed product by reducing or eliminating potential flaws such as the sinkage of materials and irregularities in the knit line of joints.The mold-making process ranges from 30 to 90 days, depending on the size and complexity of the mold. Mold making requires specialized machines and is capital intensive. At March 31, 2008, the Company used 30 EDMs (electrical discharge machines), 32 CNC (computer numerical control) milling machines and 83 NC (numerical control) milling machines in the mold-making process. Deswell is continually adding equipment to expand its mold making and injection molding capabilities.

During the year ended March 31, 2006, the Company acquired machines and equipment costing approximately $1.9 million, including three sets of EDMs, three sets of CNC milling machines and 29 sets of injection machines with clamping forces of 86 tons to 160 tons; replacing one set of CNC milling machines and 19 sets of old injection machines.

During the year ended March 31, 2007, the Company acquired machines and equipment costing approximately $2.2 million, including 83 sets of injection molding machines with clamping force of 86 tons to 1,300 tons; replacing 69 sets of old injection machines, two sets of old EDMs and three sets of old NC milling machines.

During the year ended March 31, 2008, the Company acquired machines and equipment costing approximately $1.6 million, including 22 sets of injection molding machines with clamping force of 86 tons to 250 tons; replacing 20 sets of old injection machines.

Molds produced by the Company generally weigh from 110 to 17,600 pounds and generally cost between $2,000 and $200,000.

The customer generally bears the cost of producing the molds and, as is customary in the industry, the customer owns them. However, the Company maintains and stores the molds at its factory for use in production and it is Deswell s policy generally not to make molds for customers unless the customer undertakes to store its molds at the Company s factory and uses Deswell to manufacture the related parts. In that way, the Company seeks to use its mold-making expertise to create dependence on it for the customer s parts requirements. Beginning in 2005, however, through its then newly created Export Tooling Department, Deswell s began producing molds for export to customers and thus does not use those molds to manufacture related parts.

During the year ended March 31, 2008, the Company made on average about 50 to 100 different molds every month. Management believes that the Company s skills and expertise in mold-making, coupled with having its facilities and operations in China, allow the Company to produce molds at costs substantially less than molds of comparable quality made in Japan, Korea and Taiwan.

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Plastic Injection.

During the mold-making process, suitable plastic resin for the particular product is selected and purchased. See Raw Materials, Component Parts and Suppliers, below. The completed mold is mounted onto injection machines, which are classified according to the clamping force (the pressure per square inch required to hold a mold in place during the injection molding process). At March 31, 2008, the Company had approximately 400 injection molding machines, ranging from 22 to 1,600 tons of clamping force, with most machines in the range of from 88 to 380 tons. Each of the Company s machines is capable of servicing a variety of applications and product configurations and the Company has machines, which permit the Company to fabricate plastic parts as small as a button and as large as a 3 ft. x 2 ft. case for a copy machine.

Using separate shifts, injection molding is generally conducted 24 hours a day, five to seven days per week, other than normal down time for maintenance and changing of product molds. Molding of products requiring extra concerns for appearance, such as cases for calculators, personal organizers and telephones are conducted in an isolated and dust free section of the factory. In a continuous effort to assure quality, the Company s quality control personnel inspect the products produced from each machine generally at hourly intervals during production. When defects are discovered, the Company s maintenance personnel inspect the mold and the machine to determine which is responsible. If the mold is the cause of the defect, it will be immediately removed from the machine and serviced or repaired by one of a team of technicians employed to maintain molds. The mold will then be remounted on the machine and production will continue. If the machine is the source of the defect, the Company s technicians and engineers service the machine immediately. Through this continuous vigilance to molds and machines, the Company has experienced what it believes to be a relatively low scrap rate and has been able to maintain a high level of productivity of its injection molding machines.

Finishing

After injection molding, products are finished. Finishing consists of smoothing and polishing, imprinting letters, numbers and signs through silk screening process, pad printing or epoxy ultra violet cutting, and treating the product with an anti-fog coating for a lasting and attractive appearance. Most of these functions are conducted by hand.

Electronic Products and Assemblies

In an aggregate of approximately 223,000, square feet of factory space at March 31, 2008 located at facilities in Dongguan, China, the Company manufactures and assembles electronic products and electronic assemblies for OEMs. Finished products include consumer and sophisticated studio-quality audio equipment, IPBX and commercial telephone units, network education platforms, IP switches, routers etc. Assemblies consist of PCBs with passive (e.g., resistors, capacitors, transformers, switches and wire) and active (e.g., semiconductors and memory chips) components mounted on them. During the years ended March 31, 2006, 2007 and 2008, manufacturing of electronic products accounted for approximately 54.5%, 53.4 and 56.7%, respectively, of the Company s total sales.

In assembling printed circuit boards the Company purchases printed circuit boards, surface mounted components and chips and uses PTH, BGA and SMT interconnection technologies to assemble various components onto the PCBs. Before delivery, completed PCBs are checked by in-circuit-testers and outgoing quality assurance inspections are performed.

PTH is a method of assembling printed circuit boards in which component leads are inserted and soldered into plated holes in the board. While this technology is several decades old and is labor intensive, it still has a significant market, particularly for consumer product applications.

BGA is a method of mounting an integrated circuit or other component to a PCB. Rather than using pins that consume a large area of the PCB, the component is attached to the circuit board with small balls of solder at each contact. This method allows for greater component density and is used in more complex PCBs.

SMT is the automatic process of printed circuit board assembly in which components are mounted directly to the surface of the board, rather than being inserted into holes. With this process, solder is accurately stenciled in paste form on pads located on the printed circuit board and the components are then placed onto the solder paste and fused to the melting point of the paste to establish a strong solder joint between components and the printed circuit board. The SMT process allows miniaturization of PCBs, cost savings and shorten lead paths between components

(which results in faster signal speed and improved reliability). Additionally, it allows components to be placed on both sides of the printed circuit board, a major factor for the purpose of miniaturization.

Manufacturing operations include PCB assembly, wiring and testing. The process is completed by assembling the PCBs into a plastic or metal housing that comprises the finished product. Quality assurance is then conducted in accordance with the customers requirements before the shipment.

Metal Parts Manufacturing

In an aggregate of approximately 111,000 square feet of factory space at March 31, 2008 located at facilities in Dongguan, China in the same complex and next to the Company s electronic products assembly facilities, Deswell s metal forming division manufactures metallic molds and accessory parts for use in audio equipment, routers, payphones, multimedia stations and ATMs. The Company s metal molds and metal parts (products) manufacturing accounted for approximately 2.1%, 1.9% and 2.4% of Deswell s total sales during the years ended March 31, 2006, 2007 and 2008, respectively.

Quality Control

The Company maintains strict quality control procedures for its products. At hourly intervals, the Company s quality control personnel monitor machines and molds to assure that plastic parts are free from defects.

For electronic operations, the Company s quality control personnel check all incoming components. Moreover, during the production stage, the Company s quality control personnel check all work in process at several points in the production process. Finally, after the final assembly and before shipment, the Company conducts quality assurance inspections in accordance with the customers Acceptable Quality Level, or AQL, requirements.

Plastic, electronic and metal products manufactured and assembled at the Company s facilities have a low level of product defects, and aggregate returns represented less than 3% of total net sales during each of the years ended March 31, 2006, 2007 and 2008.

In 1995, the Company earned ISO 9001 certifications for both its plastic and electronic products manufacturing operations. In April 2000, the Company also received ISO 9002 for its metal manufacturing operation. The ISO or International Organization for Standardization is a Geneva-based organization dedicated to the development of worldwide standards for quality management guidelines and quality assurance. ISO 9000, which is the first quality system standard to gain worldwide recognition, requires a company to gather, analyze, document and monitor and to make improvements where needed. ISO 9001 is the ISO level appropriate for manufacturers like the Company. The Company s receipt of ISO 9001 certification demonstrates that the Company s manufacturing operations meet the established world standards.

In August 2004, the Company s plastic injection manufacturing plant in Dongguan also obtained ISO 14001 certification, which evidences that the Company s environmental management standards or EMS meet established international standards. ISO 14000 is a series of international standards on environmental management, ISO 14001 is the most well known of these standards and is often seen as the corner stone standard of the ISO 14000 series. In January 2006, the Company s electronic and metallic manufacturing plant also obtained ISO 14001 certification.

The Company was working toward having its plastic injection manufacturing plant to obtain QS 9000 Certification but before completing that process elected to seek ISO/TS 16949 Certification. ISO/TS 16949 is an ISO Technical Specification. This specification aligns existing American (QS-9000), German (VDA6.1), French (EAQF) and Italian (AVSQ) automotive quality systems standards within the global automotive industry. Together with ISO 9001:2000, ISO/TS 16949 specifies the quality system requirements for the design/development, production, installation and servicing of automotive related products. ISO/TS 16949 has been accepted as an equivalent to QS-9000, VDA6.1, AVSQ, and EAQF. ISO/TS 16949 does not replace QS-9000; but is optional and eliminates the need for multiple certifications. Deswell obtained ISO/TS 16949 Certification in July 2006.

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Raw Materials, Component Parts and Suppliers

Plastic Resins.

The primary raw materials used by the Company in the manufacture of its plastic parts are various plastic resins, primarily ABS (acrylonitrile-butadiene-styrene). The following table shows Deswell s average cost of ABS as a percentage of the total cost of plastic products sold and as a percentage of total cost of goods sold during its last three fiscal years.

	Year ended March 31, 2008		
Average cost of ABS as a percentage of the total cost of:	**2006**	**2007**	**2008**
Plastic products sold	53%	52%	46%
Goods sold	21%	20%	17%

Because plastic resins are commodity products, the Company selects its suppliers primarily based on price. The Company has no long-term supply agreements for plastic resins. The Company currently obtains its plastic resins from suppliers in Hong Kong, Japan and Taiwan and normally maintains a three to four month inventory supply.

The Company used in excess of 17,333,000 pounds of plastic resins during the year ended March 31, 2008. Management believes that the Company s large volume purchases of plastic resin have generally resulted in lower unit raw material costs and generally has enabled the Company to obtain adequate shipments of raw materials. While the Company is not generally bound by fixed price contracts with its customers, the Company has found that increases in resin prices can be difficult to pass on to its customers and, as a consequence, a significant increase in resin prices could have, and in the past has had, a material adverse effect on the Company s operations.

The primary plastic resins used by the Company are produced from petrochemical intermediates derived from products of the natural gas and crude oil refining processes. Natural gas and crude oil markets have in the past experienced substantially cyclical price fluctuations as well as other market disturbances including shortages of supply and crises in the oil producing regions of the world. The capacity, supply and demand for plastic resins and the petrochemical intermediates from which they are produced are also subject to cyclical and other market factors. Consequently, plastic resin prices may fluctuate as a result of natural gas and crude oil prices and the capacity, supply and demand for resin and petrochemical intermediates from which they are produced.

Although the plastics industry has from time to time experienced shortages of plastic resins, the Company has not experienced to date any such shortages. Management believes that there are adequate sources available to meet the Company s raw material needs.

Component Parts and Supplies

The Company purchases over 400 different component parts from more than 1,000 suppliers and is not dependent upon any single supplier for any essential component. The Company purchases from suppliers in China, Hong Kong, the United States and elsewhere. At various times there have been shortages of parts in the electronics industry, and certain components, including PCBs and semiconductors, have been subject to limited allocations. Although shortages of parts and allocations have not had a material adverse effect on the Company s results of operations, there can be no assurance that any future shortages or allocations would not have such an effect.

Raw Metal

The primary materials used by the Company in metal molds and parts manufacturing are various metals, but purchases of raw metal were immaterial to the Company s total operations during the years ended March 31, 2006, 2007 and 2008. Typically the Company buys metals from a variety of suppliers in Hong Kong and China and has no long-term contracts with metal suppliers.

Transportation

Transportation of components and finished products to customers in Shenzhen and to and from Hong Kong and Shenzhen and Dongguan is by truck. Generally, the Company sells its products F.O.B. China or F.O.B. Hong Kong. To date, the Company has not been materially affected by any transportation problems and has found that the transition of Hong Kong to Chinese control in July 1997 has not had an adverse impact on the Company s ability to transport goods to and from Hong Kong and China.

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Customers and Marketing

The Company s customers are OEMs and contract manufacturers. The Company sells its products in the United States, Asia (Hong Kong, Japan and China) and Europe (Germany, United Kingdom, France and Italy). Net sales to customers by geographic area are determined by reference to shipping destinations as directed by the Company s customers. For example, if the products are delivered to the customer in Hong Kong, the sales are recorded as generated in Hong Kong; if the customer directs the Company to ship its products to Europe, the sales are recorded as sold to Europe. See Note 17 of Notes to Consolidated Financial Statements for the dollar amounts of export sales by geographic area for each of the years ended March 31, 2006, 2007 and 2008. Net sales as a percentage of total sales to customers by geographic area consisted of the following for the years ended March 31, 2006, 2007 and 2008:

	Year ended March 31,		
Geographic Areas	**2006**	**2007**	**2008**
United States	49.0%	42.4%	46.8
China	37.5	39.2	37.0
Europe	7.0	11.2	10.7
Hong Kong	3.0	3.4	1.7
Others	3.5	3.8	3.8
Total	100.0%	100.0%	100.0

The Company markets its products and services to existing customers through direct contact with the Company s management and direct sales personnel. The Company s sales personnel attend trade shows and the Company advertises in trade publications such as *Modern Plastics International* and *Injection Molding*. Collecting information from trade-show, as well as websites, Deswell s marketing staffs contacts existing and potential customers directly by telephone, mail, fax, e-mail via the Internet and in person, stressing Deswell s capability as a complete solution provider for plastic injection mold design, tooling and molding as well as an electronics manufacturing services, or EMS, provider of advanced technology manufacturing processes and flexible logistic services.

Major Customers

The table below sets forth each of the Company s customers which accounted for 10% or more of net sales during the year ended March 31, 2008, the category of products purchased and the percentage of total Deswell net sales from such customers during the years ended March 31, 2006, 2007 and 2008.

			Year ended March 31,		
Customer	**Product**	**Business segment**	**2006**	**2007**	**2008**
Digidesign, Inc.	Professional audio equipment	EPA and MPM(1)	17.4 %	13.3 %	17.0 %
Line 6 Manufacturing	Professional audio equipment	EPA and MPM(1)	14.5	15.1	14.3
N&J company Limited	Plastic Component	PIM(2)	N/A	*	11.8
Inter-Tel Incorporated	Professional audio equipment	EPA and MPM(1)	*	*	10.2

* Less than 10%.

N/A Not a customer during the year.

(1) Electronic products assembling and metallic parts manufacturing

segment.

(2) Plastic injection molding segment

The Company s success will depend to a significant extent on the success achieved by its customers in developing and marketing their products, some of which may be new. Many of the industry segments served by the Company s customers are subject to technological change, which can result in short product life cycles. The Company could be materially adversely affected if advances in technology or other factors reduce the marketability of essential products of its customers or if new products being developed by its customers do not attain desired levels of acceptance. If the Company was to lose any customers who account for a material portion of total net sales, or if any of these customers were to decrease substantially their purchases from the Company, the Company s revenues, earnings and financial position would be materially and adversely affected. The Company s dependence on these customers is expected to continue in the foreseeable future.

The Company s sales transactions with all of its customers are based on purchase orders received by the Company from time to time. Except for these purchase orders, the Company has no written agreements with its customers. Sales of plastic parts, electronic products and metallic products are primarily made on credit terms, with payment in United States dollars or Hong Kong dollars expected within 30 to 90 days of shipment. In certain cases, primarily new customers of electronic products, sales are supported by letters of credit and are payable in United States dollars. To date, the Company has not experienced any significant difficulty in collecting accounts receivable on credit sales. Management communicates regularly with credit sale customers and closely monitors the status of payment and in this way believes it has kept the default rate low. Additionally, plastic parts deliveries are made in several installments over a lengthy period of time, which permits the Company to withhold delivery in the event of any delinquency in payment for past shipments. While the Company has not experienced any difficulty in being paid by its major customers, there can be no assurance that the Company s favorable collection experience will continue in every case or at all. The Company could be adversely affected if a major customer were unable to pay for the Company s products or services.

Competition

Management believes that the plastic injection molding, contract electronic manufacturing and metal molds and accessories industries are each highly fragmented, although it is not aware of any empirical data defining the business segments in China. Plastic injection molding and metal molds and accessories manufacturing are characterized by a large number of relatively small operators and divisions of larger companies and contract electronic manufacturing by numerous independent manufacturers whose capabilities are evaluated by customers against each other and against the merits of in-house production. Competition in each industry is intense and many competitors in each industry are larger and have greater financial and other resources than the Company.

The Company believes that competition for plastic injection molding, contract electronic manufacturing and metal molds and parts manufacturing businesses are based on price, quality, service and the ability to deliver products in a timely and reliable basis. The Company believes that it competes favorably in each of these areas in each business segment.

Patents, Licenses and Trademarks

The Company has no patents, trademarks, licenses, franchises, concessions or royalty agreements that are material to its business.

Seasonality

For information concerning the seasonality of the Company s business, see Seasonality included under Item 5 Operating and Financial Review and Prospects.

Property, Plants and Equipment

Macao

The Company leases Units 17B and 17E, Edificio Comercial Rodrigues, 599 Avenida da Praia Grande, Macao from an unaffiliated party, each being for a term of two years to July 2009. The premises are used as trading, administrative and accounting office for the Company s plastic injection business and electronic & metallic business, respectively. The monthly rent is approximately $2,185.

Hong Kong

The Company sold its previously owned property of Unit 10-14, 19/F., Kwong Sang Hong Centre, 151-153 Hoi Bun Road, Kwun Tong, Hong Kong to an unaffiliated party for proceeds of $1,350,000 in March 2007.

Southern China

In October 2000, the Company acquired under sale and purchase agreement with third party an aggregate of approximately 112,900 square feet of manufacturing space at Block G, Wing Village Industrial Estate, Shekou, Shenzhen, China which was previously leased by the Company for the use of its plastic injection molding operations.

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Deswell paid approximately $1,461,000 to acquire this property. At March 31, 2008 the Company had closed this manufacturing facility and now holds it for sale.

In January 2000, the Company acquired under sale and purchase agreement with the local government party an aggregate of approximately 1.3 million square feet of land to construct its own manufacturing plant and dormitory buildings in Houjie, Dongguan, China. As at March 31, 2008, there were built and operational 1,070,000 square feet of factory space, 91,000 square feet of amenity space, 133,000 square feet of office building and 470,000 square feet of dormitory space. Deswell now uses this facility for its plastic manufacturing operations.

The Company leases space at various locations near its plastics manufacturing factories in Dongguan that it uses as dormitories for factory staff. Management estimates that the space leased for dormitories approximated 3,800 square feet at March 31, 2008 in Dongguan. The facilities are leased for periods of one year, with expiration dates ranging from February 2009 to June 2009. The aggregate monthly rental is approximately $1,200. During the period from July 2006 to March 2007, Deswell sold its previously owned dormitory apartments to unaffiliated parties for aggregate proceeds of $795,000.

In July 2003, the Company completed the acquisition with a third party an aggregate of approximately 244,000 square feet of land and approximately 420,000 square feet of buildings, including six blocks of dormitory buildings, a canteen, a factory building, a car park and a guard room, at Cheung On, Dongguan, China, which was previously named Kwan Hong Building. The land use period is for 50 years from February 1, 2003 to January 31, 2053. The Company paid approximately $4,186,000 to acquire this property and uses the facilities for its electronic products manufacturing operations.

At March 31, 2008, the Company leased approximately 69,400 square feet of manufacturing space in Kwanta Building, Cheung On, Dongguan, China for its contract metal manufacturing operations. These premises are leased from third party expire in May 2010. The aggregate monthly rental is approximately $8,600.

In addition, the Company leases approximately 19,000 square feet of space at various locations near its contract electronics and metal manufacturing factories in Dongguan, which are used as staff quarters. The facilities are leased from third parties for periods of one to two years and expire from October 2008 to January 2009. The aggregate monthly rental is approximately $4,700.

Management believes that Deswell will be able to renew each of the leases described above as it expires for periods comparable to the current term or find alternative space as needed.

The Company believes that its existing offices and manufacturing space, and manufacturing space in close proximity to its existing facilities, which management believes will be available as needed for limited expansion, will be adequate for the operation of its business for at least the next two years.

ITEM 4A. UNRESOLVED STAFF COMMENTS

We do not have any unresolved comments from the staff of the Securities and Exchange Commission regarding our periodic reports under the Exchange Act.

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ITEM 5. OPERATING AND FINANCIAL REVIEW AND PROSPECTS

Except for statements of historical facts, this section contains forward-looking statements involving risks and uncertainties. You can identify these statements by forward looking words including expect , anticipate , believe seek estimate . Forward looking statements are not guarantees of Deswell s future performance or results and the Company s actual results could differ materially from those anticipated in these forward-looking statements as a result of certain factors, including those set forth under the section of this Report entitled Item 3. Key Information Risk Factors . This section should be read in conjunction with the Company s Consolidated Financial Statements included under Item 18 of this Report.

Operating Results

The following discussion should be read in conjunction with the consolidated financial statements and notes thereto included later in this Report. The Company prepares its financial statements in accordance with U.S. GAAP.

General

The Company s revenues are derived from the manufacture and sale of injection-molded plastic parts and components, electrical products and subassemblies and metallic molds and accessories. JIMCO and Jetcrown Dongguan (wholly owned subsidiaries) carry on the plastics operations whereas Integrated carries out the electronics and metallic operations. The Company acquired a controlling interest in Integrated s predecessor in October 1992 and has included the results of the predecessor in its consolidated financial statements from the date of acquisition. Through December 2002, the Company owned a 51% interest in Integrated. In January 2003, the Company increased its interest in Integrated to 71% by purchasing an additional 20% from its minority shareholders in exchange for the issuance to them of an aggregate of 251,880 common shares. In April 2005, the Company increased its interest in Integrated to 76% by purchasing an additional 5% from a minority shareholder in exchange for the issuance to it of 120,000 common shares. In August 2007, the Company further increased its interest in Integrated to 100% by purchasing the remaining 24% from the minority shareholder in exchange for the issuance to them of 632,080 common shares and a cash payment of $414,000.

The Company s plastics operations are the mainstay of its business and have historically accounted for the majority of its sales. The Company carries out all of its manufacturing operations in Southern China, where it is able to take advantage of the lower overhead costs and inexpensive labor rates as compared to Hong Kong. At the same time, the proximity of the Company s factories in Southern China to Hong Kong permits the Company to manage easily its manufacturing operations from Hong Kong, facilitates transportation of its products through Hong Kong and provides the Company s plastic manufacturing operations with access to electricity from Hong Kong and to nearby water, both of which resources are needed in abundance to manufacture plastic parts and are often inadequate elsewhere in China.

Under PRC tax law in effect before January 1, 2008, we have been afforded a number of tax concessions by, and tax refunds from, China s tax authorities on a substantial portion of our operations in China by reinvesting all or part of the profits attributable to our PRC manufacturing operations. We have enjoyed preferential tax concessions in the PRC as a high-tech enterprise and have benefited from favorable overall effective income tax rates of 0.27%, 8.70 % and 1.13% for the years ended March 31, 2006, 2007 and 2008, respectively. However, on March 16, 2007, the Chinese government enacted a new unified enterprise income tax law which became effective on January 1, 2008. Under the new income tax law most domestic enterprises and foreign invested enterprises, like Deswell, would be subject to a single PRC enterprise income tax rate and gradually transfer to the new tax rate of 25% within five years. Following the implementation of the Enterprise Income Tax Law effective January 1, 2008, the State Council announced the transition rules for preferential tax policies (Guofa [2007] No.39) of January 2, 2008, for eligible enterprises previously subject to a 15% tax rate or 24% tax rate. As so announced, the new enterprise income tax rates are:

	Rate under EIT for enterprises previously subject to tax rate of	
Tax Year	**15 percent**	**24 percent**
2008	18%	25%
2009	20%	25%

2010	22%	25%
2011	24%	25%
2012	25%	25%

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Accordingly, with the enactment of new PRC Enterprise Tax effective January 1, 2008, the Company expects the benefits it previously enjoyed, such as receiving tax refunds as a result of its reinvestment of profits in certain of its subsidiaries in China and favorable concession rates, will no longer be available.

Deswell s material operations are generally organized in two segments: plastic injection molding, or the plastic segment, electronic products assembling and metallic parts manufacturing. Results from Company s metallic parts manufacturing operations have not been material to the Company s operations as a whole and have therefore been combined as the electronic and metallic segment for the table presentation and discussion below. The Company s reportable segments are strategic business units that offer different products and services. The following table sets forth present selected consolidated financial information stated as a percentages of net sales for each of the three years in the period ended March 31, 2008.

	Year ended March 31, 2006			**Year ended March 31, 2007**			**Year ended March 31, 2008**		
	Plastic Injection Molding Segment	**Electronic & Metallic Segment**	**Total**	**Plastic Injection Molding Segment**	**Electronic & Metallic Segment**	**Total**	**Plastic Injection Molding Segment**	**Electronic & Metallic Segment**	**Total**
Net sales	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Cost of sales	72.5	81.9	77.9	68.1	84.1	77.1	74.4	86.6	81.6
Gross profit	27.5	18.1	22.1	31.9	15.9	22.9	25.6	13.4	18.4
Selling, general and administrative expenses	17.7	9.7	13.1	17.4	11.2	13.9	18.4	10.3	13.6
Other income, net	(1.4)	(0.3)	(0.7)	2.5	(0.1)	1.0	4.0	(0.6)	1.3
Operating income	8.5	8.1	8.3	17.0	4.6	10.0	11.2	2.5	6.1
Interest expense									
Non-operating income, net	0.8		0.4	0.8	0.1	0.4	0.8	0.1	0.4
Income before income taxes and minority interest	9.4	8.2	8.7	17.8	4.8	10.4	12.0	2.6	6.5
Income taxes	(0.6)	0.4		1.8	0.2	0.9	0.5	(0.2)	0.1
Income before minority interests	10.0	7.8	8.7	15.9	4.6	9.5	11.5	2.8	6.4
Minority interests		1.9	1.1		1.1	0.6		0.3	0.2
Net income	10.0%	5.9%	7.6%	15.9%	3.5%	8.9%	11.5%	2.5%	6.2%

Year ended March 31, 2008 Compared to Year Ended March 31, 2007

Net Sales - The Company s net sales for the year ended March 31, 2008 were $143,806,000, an increase of $7,027,000 or 5.1% as compared to the year ended March 31, 2007. Sales to Digidesign Inc. (Digidesign), Line 6 Manufacturing (Line 6), N&J Company Limited and Inter-Tel Incorporated, the Company s four largest customers during the year ended March 31, 2008, represented approximately 53.3% of net sales for the year. See Item 4 Information on the Company Major Customers .

The increase in sales was mainly related to the increase in sales at our electronics and metallic segment of $ 7,634,000 offsetting the decrease in sales at our plastic segment of $607,000. This represented an increase of 9.9% and a decrease of 1.0% respectively, as compared with the net sales from the segments in the prior year.

Revenue from our plastics segment during fiscal 2008 amounted to $58,858,000, including $28,000 of intersegment revenue, as compared to revenue in this segment during fiscal 2007 of $59,587,000, including $150,000 of intersegment revenue. The revenue decrease at our plastic segment was mainly due to the decrease in orders from existing customers of $12,984,000 of which $4,655,000 was related to plastic component sales of printer products and $5,402,000 was related to telecommunication products, offsetting the increase in orders from other existing and new customers of $11,397,000 and $981,000 respectively. Of the increase, $8,811,000 was related to plastic component sales of electronic entertainment products.

Revenue from our electronic and metallic segment during fiscal 2008 amounted to $88,916,000 , including $3,940,000 of intersegment sales of electronic products as compared to revenue in this segment during fiscal 2007 of $80,311,000 , including $2,969,000 of intersegment sales of electronic products. The revenue increase at our electronic and metallic segment was mainly due to an increase in OEM orders of electronic and metallic products from existing and new customers of $12,958,000 and $2,887,000 respectively, and an increase in distribution sales of $682,000 during the year, offsetting the decrease in orders from existing customers of $8,452,000 in electronic sales and $442,000 in metallic sales respectively. Of the increases, $9,037,000 and $5,403,000 were related to orders of professional audio equipment and telecommunication equipment, respectively.

Gross Profit - The gross profit for the year ended March 31, 2008 was $26,433,000, representing a gross profit margin of 18.4%. This compares with the overall gross profit and gross profit margin of $31,273,000 or 22.9% for the year ended March 31, 2007.

Gross profit in the plastics segment decreased by $3,867,000 to $15,070,000 or 25.6% of net sales, for the year ended March 31, 2008 compared to $18,937,000 or 31.9% of net sales, for the year ended March 31, 2007. The decrease in gross margin was mainly attributed to the combined effect of a change in customer and product mix and the increase in resin cost during the year and the increase in labor cost and overhead cost of 2.4% and 4.0% of net sales, respectively, as compared with prior year, as a result of the renminbi appreciation and implementation of a new China Labor Ordinance commencing January 1, 2008.

Gross profits in the electronic & metallic segment decreased by $973,000 to $11,363,000, or 13.4% of net sales, for the year ended March 31, 2008 compared to $12,336,000 or 15.9% of net sales, for the last year. This was mainly attributed to the change in customer and product mix and the increased material pricing pressure on some of our electronic materials; the increase in labor cost of 1.4% of net sales, the increase in value added tax cost as a result of the change in value added tax policy by the government of China for different categories of export products in the first quarter of fiscal 2008 and an average of 8.7% appreciation in Chinese renminbi currency in the year where most of our direct overhead and increased local material souring are denominated, as compared with last year.

Selling, General and Administrative Expenses SG&A expenses for the year ended March 31, 2008 were $19,601,000, amounting to 13.6% of total net sales, as compared to $18,957,000 or 13.9% of total net sales for the year ended March 31, 2007.

The SG&A expenses in the plastic segment increased by $506,000 or 4.9% to $10,823,000 or 18.4% of net sales, for the year ended March 31, 2008 compared to $10,317,000 or 17.4% of net sales, for the prior year. The increase was primarily related to an increase in staff and welfare cost of $712,000, audit and professional expenses of $170,000, depreciation expenses of $161,000 and selling expenses of 153,000 and estate duty and usage tax of $168,000. Together these offset the decrease in director remuneration of $526,000 and decrease in stock based compensation cost of $509,000 as compared with last year.

The SG&A expenses in the electronic & metallic segment increased by $138,000 or 1.6% to $8,778,000 or 10.3% of net sales, for the year ended March 31, 2008 compared to $8,640,000 or 11.2% of net sales for the prior year. The increase was primarily related to the increase in management and staff salary and welfare expenses of $305,000 and staff commission expenses of $92,000 offsetting the decrease in selling logistic expenses of $289,000 as compared with last year.

Other operating income - Other operating income was $1,838,000 for the year ended March 31, 2008, an increase of $462,000 as compared with the other operating income of $1,376,000 for the year ended March 31, 2007.

On a segment basis, other operating income attributable to the plastic segment increased $861,000 to $2,346,000 in the year ended March 31, 2008, as compared to other expenses of $1,485,000 for the year ended March 31, 2007. The increase was mainly attributed to an increase in exchange translation gain of $1,193,000 relating to a subsidiary having Chinese renminbi functional currency, and a decrease in allowance for doubtful receivables of $168,000, offsetting decrease in gain on disposal of fixed assets of $560,000 as compared with the prior year.

Other operating expenses attributable to the electronic & metallic segment increased $400,000, to operating expenses of $508,000 in the year ended March 31, 2008, as compared to other expenses of $108,000 for the year ended March 31, 2007. This increase in other operating expenses was primarily attributable to an impairment in goodwill relating to a metallic subsidiary of $317,000 as described in note 8 to the consolidated financial statements, the increase in exchange loss of $231,000 and the decrease in gain on disposal of fixed assets of $126,000 offsetting the decrease in allowance for doubtful receivables of $204,000 during the year ended March 31, 2008.

Operating Income - Operating income was $8,670,000 for the year ended March 31, 2008, a decrease of $5,022,000, or 36.7% as compared with the prior year.

On a segment basis, the operating income of the plastics segment decreased $3,512,000 to $6,593,000 or 11.2% of net sales in the year ended March 31, 2008 compared to $10,105,000 or 17.0% of net sales in the prior year. The decrease in operating income was attributable to the decrease in gross profit and the increase in SG&A offsetting the increase in other operating income as described above.

The operating income of the electronics & metallic segment decreased $1,511,000 to $2,077,000 or 2.4% of net sales, in the year ended March 31, 2008 compared to $3,588,000 or 4.6% of net sales in the prior year. The decrease in operating income was attributable to the decrease in gross profit, coupled with the increase in SG&A expenses and other operating expenses as described above.

Non-operating income Non-operating income for the year decreased by $26,000 to $521,000 for the year ended March 31, 2008 as compared with last year. This is mainly attributed to the decrease in interest income of $20,000 and rental income of $70,000 offsetting the decrease in impairment loss on marketable securities of $67,000 as compared with prior year.

Income Taxes Income tax for the year ended March 31, 2008 is comprised of income tax expenses of $654,000 and a deferred tax asset of $550,000, compared with income tax expenses of $624,000 and a deferred tax provision of $615,000 in the prior year.

On a segment basis, the income tax of the plastic segment is comprised of income tax expenses of $637,000 and a deferred tax asset of $321,000 for the year ended March 31, 2008, as compared with income tax expenses of $472,000 and a deferred tax provision of $615,000 in the prior year. The decrease in income tax expense was mainly attributed to the additional tax provision made during the corresponding year ended March 31, 2007 as a result of an additional tax assessment in connection with the amounts of assessable profits and the date of commencement of the first profitable year for our Dongguan plastic subsidiary. As a result, we made a tax provision of approximately $154,000, $92,000 and $166,000 for taxable calendar years 2004, 2005 and 2006 respectively, at an applicable tax rate of 24% with a 50% tax exemption for the calendar years 2004 to 2006. The tax assessment and payment for calendar years 2004, 2005 and 2006 were settled during the year ended March 31, 2008. For taxable calendar year 2007, we initially provided an applicable national tax rate of 24% and 3% local tax rate but we have recently been approved as an Export-oriented Enterprises by the local tax authority and enjoyed a lower tax rate of 12%. Hence, an over-provision of income tax was made in the last quarter. The income tax expenses for the electronic & metallic segment is comprised of income tax expenses of $18,000 and a deferred tax asset of $230,000 as compared with income tax expenses of $152,000 in the prior year.

Minority Interest There was no minority interest as of March 31, 2008, whereas the minority interest for the five months ended August 31, 2007 and year ended March 31, 2008 represent a 24% minority interest in Integrated International Limited, the holding company holding the capital stock of Deswell s electronic and metallic subsidiaries. In August 2007, the Company acquired an additional 24% interest in Integrated, increasing its ownership in that subsidiary from 76% to 100%. As a result of the decrease in Minority interest in Deswell s electronic & metallic segment during the year, the dollar amount of minority interest decreased by $605,000 from $833,000 for the year ended March 31, 2007.

Net Income - Net income was $8,859,000 for the year ended March 31, 2008, a decrease of $3,308,000 or 27.2 %, as compared to net income of $12,167,000 for the year March 31, 2007. Net income as a percentage of net sales decreased from 8.9% to 6.2 % for the year ended March 31, 2008. The decrease in net income was mainly the result of the decrease in operating income offsetting the decrease in income tax expenses and decrease in minority interest, as described above.

Net income for the plastic segment decreased by $2,732,000 or 28.9 % to $6,735,000 for the year ended March 31, 2008 compared to $9,467,000 for the prior year 2007. The decrease in net income of the plastic segment was mainly the result of the decrease in operating income offsetting the decrease in income tax expenses, as described above.

Net income for the electronic & metallic segment decreased by $577,000 or 21.4% to $2,124,000 for the year ended March 31, 2008 compared to $2,701,000 for the prior year 2007. The decrease in net income of the electronic & metallic segment was mainly the result of the decrease in operating income offsetting the decrease in income tax expenses and in minority interest, as described above.

Year ended March 31, 2007 Compared to Year Ended March 31, 2006

Net Sales Deswell s net sales for the year ended March 31, 2007 were $136,779,000, an increase of $21,503,000 or 18.7% as compared to year ended March 31, 2006. Sales to Line 6 Manufacturing (Line 6), Digidesign Inc. (Digidesign), VTech Telecommunications Limited (VTech), Peavey Electronics Coop. (Peavey), the Company s four largest customers during the year ended March 31, 2007, represented approximately 51.5% of net sales for the year.

The increase in total sales was mainly related to the increase in sales at our plastic segment and electronics and metallic segment of $11,161,000 and $10,342,000 respectively. This represented increases of 23.1% and 15.4% respectively, as compared with the net sales from these segments in fiscal 2006.

Revenue from our plastics segment during fiscal 2007 amounted to $59,587,000, including $150,000 of intersegment revenue, as compared to revenue in this segment during fiscal 2006 of $49,429,000, including $1,152,000 of intersegment revenue. The revenue increase in our plastic segment was primarily a result of the increase in orders from a telecommunications customer of $7,991,000 and from other existing customers of $3,988,000 over the corresponding period in the prior year; and from orders from new customers during fiscal 2007 of $9,125,000. Together the aggregate of these increases and additions from new customers offset the decrease in orders from existing customers of $9,943,000. Accordingly, the net increase resulted from a change in customer mix as compared with fiscal 2006.

Revenue from our electronic and metallic segment during fiscal 2007 amounted to $80,311,000, including $2,969,000 of intersegment sales of electronic products as compared to revenue in this segment during fiscal 2006 of $68,925,000, including $1,926,000 of intersegment sales of electronic products. The revenue increase in our electronic and metallic segment was principally caused by an increase in orders for electronic products from both existing and new customers of $11,262,000 and $2,185,000, respectively, offsetting the decrease in orders from existing customers of $2,462,000 in electronic sales, $638,000 in metallic sales and $5,000 in distribution sales respectively. The net increase was the result of a change in products and customer mix during fiscal 2007 as compared with fiscal 2006. The increase in OEM product sales was mainly from sales of professional audio equipment products.

Gross Profit - The gross profit for the year ended March 31, 2007 was $31,273,000, representing a gross profit margin of 22.9%. This compares with the overall gross profit and gross profit margin of $25,426,000 or 22.1% for the year ended March 31, 2006.

Gross profit in the plastics segment increased by $5,647,000, to $18,937,000 or 31.9% of net sales, for the year ended March 31, 2007 compared to $13,290,000 or 27.5% of net sales, for the year ended March 31, 2006. The improved gross margin was mainly attributed to a change in customer and product mix where lower margin assembly sales decreased by approximately 36% and higher margin orders increased during the year as compared with prior year; and our continued tight control of factory overhead; despite the 40.5% increase in labor cost as a result of the approximately $1,005,000 in severance expenses paid upon the closure of our Shenzhen plastic plant during the year ended March 31, 2007 and an average 14% increase in labor rate as compared with fiscal 2006.

Gross profit in the electronic and metallic segment increased by $200,000 to $12,336,000, or 15.9% of net sales, for the year ended March 31, 2007 compared to $12,136,000 or 18.1% of net sales, for fiscal 2006. This was mainly attributed to the change in customer and product mix and the increased material pricing pressure on some of our electronic materials; an approximately 32% increase in labor rates and an average of 3.8% appreciation in Chinese renminbi currency during fiscal year 2007 where most of our direct overheads and increased local material sourcing are denominated, as compared with fiscal 2006.

Selling, General and Administrative Expenses SG&A expenses for the year ended March 31, 2007 were $18,957,000, amounting to 13.9% of total net sales, as compared to $15,052,000 or 13.1% of total net sales for the year ended March 31, 2006. The SG&A expenses in the plastic segment increased by $1,795,000 or 21.1% to $10,317,000 or 17.4% of net sales, for the year ended March 31, 2007 compared to $8,522,000 or 12.7% of net sales, for the prior year. The increase was primarily related to a stock based compensation charges of $820,000, an increase in management remuneration of $402,000 and approximately $388,000 in severance expenses paid upon the closure of one of our plastic manufacturing facilities during fiscal 2007, coupled with an increase in selling expenses of $140,000 and depreciation expense of $162,000 as a result of the increase in sales activities and our machinery investment during the year ended March 31, 2007 as compared with last year.

The SG&A expenses in the electronic and metallic segment increased by $2,110,000 or 32.3% to $8,640,000 or 11.2% of net sales, for the year ended March 31, 2007 compared to $6,530,000 or 9.7% of net sales for fiscal 2006. The increase was primarily related to the increase in salary expenses and staff welfare expenses of $1,265,000 and $61,000; as a result of both increase in staff rate and headcounts in various departments. Moreover, there were an increase in selling logistic expenses of $438,000 and increase in other general expense of $338,000 during the year, as a result of the increase in sales activities as compared with last year.

Other operating income - Other operating income was $1,376,000 for the year ended March 31, 2007, an increase of $2,199,000 as compared with the other operating expenses of $823,000 for the year ended March 31, 2006.

On a segment basis, other operating income attributable to the plastic segment increased $2,140,000 to $1,484,000 in the year ended March 31, 2007, as compared to other expenses of $656,000 for the year ended March 31, 2006. The increase was primarily attributable to an exchange transaction adjustment of $1,166,000 of a subsidiary having non-United States dollar functional currencies and a decrease in doubtful accounts receivable provision of $766,000, of which $970,000 was related to financial issues of a telecommunication customer due stemming from a failed European product launch in the year ended March 31, 2006. This, together with the gain on

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disposal of fixed assets of $560,000, which mainly resulted from our disposal of premises we owned that we used to house employees, upon closure of plastic manufacturing facilities during fiscal 2007, offset a $173,000 tax refund we received on our reinvestment of certain retained earnings in one of our PRC subsidiaries and the increase in other exchange loss of $163,000 as compared with the prior year in 2006.

Other operating income attributable to the electronic & metallic segment increased $60,000, to operating expenses of $108,000 in the year ended March 31, 2007, as compared to other expenses of $168,000 for the year ended March 31, 2006. This increase was primarily due to the increase in gain on disposal of fixed assets of $128,000 and the decrease in bad debt write off of $169,000 offsetting the increase in allowance for doubtful receivables of $206,000 during the year ended March 31, 2007.

Operating Income Operating income was $13,692,000 for the year ended March 31, 2007, an increase of $4,141,000, or 43.3% as compared with fiscal 2006. On a segment basis, the operating income of plastics segment increased $5,992,000 to $10,104,000 or 17.0% of net sales, in the year ended March 31, 2007 compared to $4,112,000 or 8.5% of net sales in fiscal 2006. The increase in operating income was attributable to the increase in gross profit and other operating income offsetting the increase in SG&A expenses as described above.

The operating income of electronics & metallic segment decreased $1,850,000 to $3,588,000 or 4.6% of net sales, in the year ended March 31, 2007 compared to $5,438,000 or 8.1% of net sales in fiscal 2006. The decrease in operating income was attributable to the increase in SG&A expenses offsetting the increase in gross profit and decrease in other operating expenses as described above.

Income Taxes Income tax for the year ended March 31, 2007 comprised of income tax expenses of $624,000 and realization of deferred income tax assets of $615,000, compared with income tax expenses of $267,000 and a deferred income tax credit of $294,000 in fiscal 2006.

On a segment basis, the income tax of the plastic segment comprised of income tax expenses of $472,000, realization of deferred income tax of $294,000 and a deferred tax provision of $321,000 for the year ended March 31, 2007, as compared with income tax expenses of $8,000 and deferred income tax credit of $294,000 in fiscal 2006. The increase was primarily related to the realization of deferred income tax assets of $294,000; an under-provision of $253,000 for taxable year 2004 and 2005 and a current year provision of $197,000 as a result of the reassessment of the first taxable year from 2004 to 2002 by the PRC Tax Bureau for a plastic manufacturing subsidiary during the year and a deferred income tax provided of $321,000. The income tax expenses for the electronic & metallic segment decreased $107,000, to $152,000 for the year ended March 31, 2007. This was mainly due to the recognition of refundable income taxes of $124,000 for the year ended March 31, 2007.

Minority Interest - Minority interests represent a 24% minority interest in Integrated International Limited, the holding company holding the capital stock of Deswell s electronic & metallic subsidiaries. In April 2005, the Company acquired an additional 5% interest in Integrated, increasing its ownership in that subsidiary from 71% to 76%. In June 2005, the Company liquidated its marketing subsidiary in which it held a 49% minority interest. The decrease in the dollar amount of minority interest to $833,000 for the year ended March 31, 2007, from $1,240,000 for fiscal 2006, represented the decrease in operating income in the electronics and metallic subsidiaries during the year.

Net Income - Net income was $12,167,000 for the year ended March 31, 2007, an increase of $3,388,000 or 38.6%, as compared to net income of $8,779,000 for the year March 31, 2006. Net income as a percentage of net sales increased from 7.6% to 8.9% for the year ended March 31, 2007. The increase in net income was mainly the result of the increase in operating income and the decrease in minority interest offsetting the increase in income tax expenses, as described above.

Net income for the plastic segment increased by $4,660,000 or 96.9% to $9,467,000 for the year ended March 31, 2007 compared to $4,807,000 for fiscal 2006. The increase in net income of the plastic segment was mainly the result of the increase in operating income offsetting the increase in income tax expenses, as described above.

Net income for the electronic & metallic segment decreased by $1,271,000 or 32.0% to $2,701,000 for the year ended March 31, 2007 compared to $3,972,000 for fiscal 2006. The decrease in net income of the electronic & metallic segment was mainly the result of the decrease in operating income offsetting an increase in other income, a decrease in income tax expenses and in minority interest, as described above.

Seasonality

The following table sets forth certain unaudited quarterly financial information for the twelve quarters in the three-year period ended March 31, 2008 (in thousands):

	Year ended March 31,											
	2006				2007				2008			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Net sales	$30,075	$29,046	$29,972	$26,183	$31,689	$35,715	$39,002	$30,373	$38,452	$38,414	$35,416	$31,524
Gross profit	7,640	6,209	6,561	5,016	8,446	8,865	8,754	5,208	6,762	6,698	7,923	5,050
Operating income	3,600	3,126	2,632	193	3,866	3,973	4,016	1,837	3,304	1,681	3,033	652
Net income	3,151	2,795	2,380	453	3,403	3,597	3,605	1,562	3,111	1,755	2,955	1,038

The first calendar quarter (the fourth quarter of the fiscal year) is typically the Company s slowest sales period because, as is customary in China, the Company s manufacturing facilities in China are closed for two weeks for the Chinese New Year holidays. The Company does not experience any other significant seasonal fluctuations.

Impact of Inflation

The Company believes that inflation has not had a material effect on its business. Although the Company has found it difficult to increase the prices of its products in order to keep pace with inflation, particularly in its plastics operations, the Company believes that the location of its manufacturing operations in Southern China has resulted in a lower cost base which still provides it with a competitive advantage. Accordingly, the Company is reliant upon increasing its transaction volume in order to compensate for the effects of inflation.

Exchange Rates

The Company sells most of its products and pays for most components in either Hong Kong dollars or U.S. dollars. Labor cost and overhead expenses of the Company are paid primarily in Hong Kong dollars and RMB, respectively.

Since 1983, the exchange rate of the Hong Kong dollar to the U.S. dollar has been fixed by the Hong Kong government at approximately HK$7.80 to US$1.00 and accordingly Hong Kong Dollars has not, to date, represented a currency exchange risk to U.S. dollars. This could change in the future if those in Hong Kong arguing for a floating currency system prevail in the ongoing debate over whether to continue to peg the Hong Kong dollar to the U.S. dollar. There can be no assurance that the Chinese government will continue to maintain the present currency exchange mechanism in Hong Kong and if the currency exchange mechanism between the Hong Kong dollar and the U.S. dollar were changed, the Company s results of operations and financial condition could be materially adversely affected.

Until August 2005, exchange rate fluctuations between the RMB and the US dollar had not had a significant impact on the Company s operating results. In 1994, China adopted a floating currency system whereby the official exchange rate is equal to the market rate. Between 1994 and July 2005, the market and official RMB rates were unified and the value of the RMB was essentially pegged to the US dollar and was relatively stable. During its fiscal years ended March 31, 2004 and 2005, the average exchange rate was 8.28 Yuan per US$1.00. On July 21, 2005, the People s Bank of China adjusted the exchange rate of RMB to the U.S. dollar by linking the RMB to a basket of currencies and simultaneously setting the exchange rate of RMB to U.S. dollars, from 1:8.27, to a narrow band of around 1:8.11, resulting in an approximately 2% appreciation in the value of the RMB against the U.S. dollars. The exchange rates of RMB to the U.S. dollars have further appreciated during the period since August 2005 to 1:6.823 as at July 25, 2008. As a consequence, and in addition to increases in plastic resin and labor costs, in each of the years ended March 31, 2006, 2007 and 2008, Deswell s operating costs increased from levels existing prior to the exchange rate adjustment. Since the Company was not able to pass on to its customers most of these cost increases by price increases of its products, Deswell s gross margins, operating income and net income were adversely affected.

The four main currencies in the basket to which the RMB was linked in July 2005 were the US dollar, the Euro, the Japanese yen and the Korean won. In the months since July 2005, further appreciation against the US dollar continued to occur and by July 25, 2008, the RMB had risen to 6.823 to the US dollar. If this trend continues or the Chinese government allows a further and significant RMB appreciation, Deswell s operating costs would further increase and its financial results would be adversely affected by such increase. If Deswell determined to pass onto its customers through price increases the effect of increases in the Chinese RMB relative to the U.S. dollar, it

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would make the Company s products more expensive in global markets, such as the United States and the European Union. This could result in the loss of customers, who may seek, and be able to obtain, products comparable to those Deswell offers in lower-cost regions of the world.

We did not hedge our currency risk during the years ended March 31, 2006, 2007 and 2008 and at March 31, 2008, we had no open forward currency contracts. We continually review our hedging strategy and there can be no assurance that hedging techniques we may implement will be successful or will not result in charges to our results of operations.

Liquidity and Capital Resources

For the year ended March 31, 2008, net cash generated from operations totaled $16,418,000 , including net income of $8,859,000 and depreciation and amortization of $6,940,000. Accounts receivable increased by $334,000, over levels at March 31, 2007, primarily as a result of the increase in sales and the decrease in provision of doubtful account receivable of $1,156,000. Inventories decreased by $3,033,000, over levels at March 31, 2007, primarily resulting from the decrease in stock of electronic parts. Accounts payable decreased by $3,338,000 over levels at March 31, 2007, primarily because of the decrease in materials purchases. For the year ended March 31, 2007, net cash generated from operations totaled $15,807,000, including net income of $12,167,000 and depreciation and amortization of $5,274,000.

Net cash used in investing activities amounted to $7,369,000 and $4,580,000 for the years ended March 31, 2008 and 2007, respectively. Capital expenditures during these periods totaled $7,288,000 and $7,812,000, respectively. There were no acquisitions of marketable securities during either of these periods. Our capital expenditures were primarily related to the renovation of our Dongguan manufacturing plant and our acquisition of plant and machinery for our production facilities in China.

Net cash used in financing activities for the years ended March 31, 2008 and 2007 were $8,537,000 and $10,792,000, respectively. Net cash we used in financing activities during the year ended March 31, 2008 was primarily to fund the our dividend payments to shareholders of $9,523,000, netting off the proceeds of $986,000 from the exercise of stock options from directors and employees. Net cash we used in financing activities during the year ended March 31, 2007 was primarily to fund our dividend payments to shareholders of $11,809,000, dividend payments to minority shareholders of subsidiaries of $582,000, netting off the proceeds of $950,000 from the exercise of stock options from directors and employees and the decrease in restricted cash of $649,000.

As a consequence of the fixed exchange rate between the Hong Kong dollar and the U.S. dollar, interest rates on Hong Kong dollar borrowings are similar to U.S. interest rates. The Hong Kong Prime Rate was decreased from 7.75% to 5.25% during the year ended March 31, 2008.

At March 31, 2008, the Company had cash and cash equivalents of $22,718,000. At that date, Deswell had no committed credit facilities and no restricted cash. Deswell expects that working capital requirements and capital additions will continue to be funded through cash on hand and internally generated funds. The Company s working capital requirements are expected to increase in line with the growth in the Company s business.

We had capital commitments for construction of our Dongguan plastic injection-molding manufacturing plant, purchase of plant and machinery of $432,000 and for purchase of plant and machinery and system upgrade of our electronic and metallic division of $169,000, respectively as of March 31, 2008. We expect that internally generated funds will be sufficient to satisfy its cash needs for at least the next 12 months. However, we may choose to obtain debt or equity financing if we believe it appropriate to accelerate the phase IV construction of its Dongguan plastic plant.

A summary of our contractual obligations and commercial commitments as of March 31, 2008 is as follows:

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		Payments due by period (in thousands)			
Contractual obligations	Total	Year ending March 31, 2009	Period from April 1, 2009 to March 31, 2011	Period from April 1, 2010 to March 31, 2013	Period after March 31, 2013
Long-term bank borrowing	$	$	$	$	$
Capital (finance) lease obligations					
Operating lease payments	363	230	133		
Capital expenditures	777	777			
Purchase obligations	11,004	11,003	1		
Other long-term liabilities					
Total	$ 12,144	$ 12,010	$ 134	$	$

Off Balance Sheet Arrangements

We do not use off-balance sheet financing arrangements, such as securitization of receivables or obtaining access to assets through special purpose entities.

Critical Accounting Policies

The Company prepares its consolidated financial statements in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires the Company to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amount of revenues and expenses during the reporting period. On an on-going basis, the Company evaluates its estimates and judgments, including those related to inventories and the valuation of long-lived assets. The Company bases its estimates and judgments on historical experience and on various other factors that the Company believes are reasonable. Actual results may differ from these estimates under different assumptions or conditions.

The following critical accounting policies affect the more significant judgments and estimates used in the preparation of the Company s consolidated financial statements.

Inventories Inventories are stated at the lower of cost or market value. For the year ended March 31, 2008, cost was determined on the weighted average basis, a change from the first-in, first-out basis that was used for the years ended March 31, 2007 and 2006. The change to using a cost determination basis for the year ended March 31, 2008 had no material impact on net income reported on the consolidated statement of income for that year and would have had no material effect on net income reported on the consolidated statements of income for the years ended March 31, 2006 and 2007 if the cost-determination basis had been used for those years. Work-in-progress and finished goods inventories consist of raw materials, direct labor and overhead associated with the manufacturing process. Write down of potentially obsolete or slow-moving inventory are recorded based on management s analysis of inventory levels.

Valuation of long-lived assets - The Company periodically evaluates the carrying value of long-lived assets to be held and used, including other intangible assets subject to amortization, when events and circumstances warrant such a review. The carrying value of a long-lived asset is considered impaired when the anticipated undiscounted cash flow from such asset is separately identifiable and is less than its carrying value. In that event, a loss is recognized based on the amount by which the carrying value exceeds the fair market value of the long-lived asset. Fair market value is determined primarily using the anticipated cash flows discounted at a rate commensurate with the risk involved. Losses on long-lived assets to be disposed of are determined in a similar manner, except that fair market values are reduced for the cost to dispose.

Foreign currency translation - The consolidated financial statements of the Company are presented in U.S. dollars as the Company is incorporated in the British Virgin Islands where the currency is the U.S. dollar. The Company s subsidiaries conduct substantially all of their business in Hong Kong dollars, Chinese renminbi or U.S. dollars. The exchange rates between the Hong Kong dollars and the U.S. dollar were approximately 7.78, 7.78 and 7.782 as of March 31, 2006, 2007 and 2008, respectively.

All transactions in currencies other than functional currencies during the year are translated at the exchange rates prevailing on the transaction dates. Related accounts payable or receivable existing at the balance sheet date denominated in currencies other than the functional currencies are translated at period end rates. Gains and losses resulting from the translation of foreign currency transactions and balances are included in income.

On consolidation, the financial statements of subsidiaries are translated from Hong Kong dollars and Chinese renminbi, being the functional currencies of the Company s subsidiaries, into U.S. dollars in accordance with SFAS No. 52, Foreign Currency Translation . Accordingly all assets and liabilities are translated at the exchange rates prevailing at the balance sheet dates and all income and expenditure items are translated at the average rates for each of the years. The exchange rates between the Chinese renminbi and the U.S. dollar were approximately 8.09, 7.78 and 7.1076 as of March 31, 2006, 2007, and 2008, respectively. All exchange differences arising from translation of subsidiaries financial statements are recorded as a component of comprehensive income.

Allowance for doubtful account - The Company regularly monitors and assesses the risk of not collecting amounts owed to the Company by customers. This evaluation is based upon a variety of factors including: ongoing credit evaluations of its customers financial condition, an analysis of amounts current and past due along with relevant history and facts particular to the customer. Based upon the results of this analysis, the Company records an allowance for uncollectible accounts for this risk. This analysis requires the Company to make significant estimates, and changes in fact and circumstances could result in material changes in the allowance for doubtful accounts. Unanticipated changes in the liquidity or financial position of the company s customers may require additional provisions for doubtful accounts.

Income taxes - The Company adopted the provisions of Financial Accounting Standard Board (FASB) Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement NO. 109 (FIN 48), which clarifies the accounting for uncertainty in income taxes recognized by prescribing a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides accounting guidance on de-recognition, classification, interest and penalties, disclosure and transition.

Recent Changes in Accounting Standards

In September 2006, the FASB issued Statement of Financial Accounting Standards (SFAS) No. 157, Fair Value Measurements. SFAS No. 157 establishes a common definition for fair value to be applied to US GAAP guidance requiring use of fair value, establishes a framework for measuring fair value, and expands disclosure about such fair value measurements. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007. The adoption of the provisions of SFAS 157 related to financial assets and liabilities, and other assets and liabilities that are carried at fair value on a recurring basis is not anticipated to materially impact the Company s consolidated financial position, results of operations and cash flows. The FASB provided for a one-year deferral of the provisions of SFAS 157 for non-financial assets and liabilities that are recognized or disclosed at fair value in the consolidated financial statements on a non-recurring basis. The Company is currently assessing the impact of SFAS No. 157 for non-financial assets and liabilities that are recognized or disclosed on a non-recurring basis.

In February 2007, the FASB issued SFAS No. 159 The Fair Value Option for Financial Assets and Financial Liabilities including an amendment of FASB Statement No. 115 (SFAS No. 159), which permits entities to choose to measure many financial instruments and certain other items at fair value. The fair value option established by this Statement permits all entities to choose to measure eligible items at fair value at specified election dates. A business entity shall report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. Adoption is required for fiscal years beginning after November 15, 2007 and is required to be adopted by the Company in the first quarter of fiscal year 2009. Early adoption is permitted as of the beginning of a fiscal year that begins on or before November 15, 2007, provided the entity also elects to apply the provisions of SFAS Statement No. 157. The Company is currently evaluating the impact of SFAS No. 159 on its consolidated financial statements and is not expected to have material impact on the Company s financial position, results of operations and cash flows.

In June 2007, The Emerging Issues Task Force, or EITF, of SASB ratified EITF Issue 06-11 Accounting for the Income Tax Benefits of Dividends on Share-Based Payments Awards (EITF 6-11). EITF 06-11 provides that tax benefits associated with dividends on share-based payment awards be recorded as a component of additional paid-in capital. EITF 06-11 is effective on a prospective basis, for fiscal years beginning after December 15, 2007 and is required to be adopted by the Company in the first quarter of fiscal year 2009. The Company is currently assessing the impact of EITF 06-11 on its consolidated financial position and results of operations.

In December 2007, FASB issued SFAS No. 141 (revised 2007) Business Combinations (SFAS No. 141R). The objective of SFAS No. 141R is to improve the relevance, presentational faithfulness, and comparability of the information that a reporting entity provides in its financial reports about a business combination and its effects. SFAS No. 141R is effective for financial statements issued for fiscal years beginning on or after December 15, 2008 and is required to be adopted by the Company in the first quarter of fiscal year 2010. The Company is evaluating the impact, if any, of the adoption of SFAS No. 141R. The impact will depend on future acquisitions. It is not expected to have material impact on the Company s financial position, results of operations and cash flows.

In December 2007, FASB issued SFAS No. 160 Non-controlling Interest in Consolidated Financial Statements . SFAS No. 160 amends Accounting Research Bulletin No. 51, Consolidated Financial Statements, to establish accounting and reporting standards for the non-controlling interest in a subsidiary and for the deconsolidation of a subsidiary. SFAS No. 160 defines a non-controlling interest, sometimes called a minority interest, is the portion of equity in a subsidiary not attributable, directly or indirectly, to a parent . The objective of SFAS No. 160 is to improve the relevance, comparability, and transparency of the financial information that a reporting entity provides in its consolidated financial statements. SFAS No. 160 is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008 and is required to be adopted by the Company in the first quarter of fiscal year 2010. The Company is evaluating the impact, if any, of the adoption of SFAS No. 160. It is not expected to have material impact on the Company s financial position, results of operations and cash flows.

In March 2008, the FASB issued SFAS No. 161 Disclosures about Derivative Instruments and Hedging Activities amendment of FASB Statement No. 133 (SFAS 161). This statement changes the disclosure requirements for derivative instruments and hedging activities. Entities are required to provide enhanced disclosures stating how and why an entity uses derivative instruments; how derivatives and related hedged items are accounted for under SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities (SFAS 133) and its related interpretations; and how derivative instruments and related hedge items affect an entity s financial position, financial performance and cash flows. SFAS 161 is effective in fiscal years beginning after November 15. 2008 and is required to be adopted by the Company in the first quarter of fiscal year 2010. The Company does not expect the adoption of SFAS 161 will have a material impact on the Company s disclosures.

In May 2008, the FASB issued SFAS No. 162, The Hierarchy of Generally Accepted Accounting Principles. SFAS No. 162 is intended to improve financial reporting by identifying a consistent framework, or hierarchy, for selecting accounting principles to be used in preparing financial statements that are presented in conformity with U.S. generally accepted accounting principles (GAAP) for nongovernmental entities. SFAS No. 162 is effective 60 days following the SEC s approval of the Public Company Accounting Oversight Board Auditing amendments to AU Section 411, The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles. The Company does not anticipate that the provisions of SFAS No. 162 will have an impact on the Company s consolidated results of operations, financial position and cash flows.

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ITEM 6. DIRECTORS, SENIOR MANAGEMENT AND EMPLOYEES

Directors and Senior Management

The directors and executive officers of the Company at August 1, 2008 are as follows:

Name	Age	Position(s) with Company
Lau Pui Hon (Richard Lau)	63	Chairman of the Board of Directors
Franki S. F. Tse	44	Chief Executive Officer
Li Chin Pang (C. P. Li)	62	Executive Director of Manufacturing and Administration for Plastic Operations and Member of the Board of Directors
Leung Chi Wai (C. W. Leung)	53	Executive Director of Engineering for Plastic Operations and Member of the Board of Directors
Hung-Hum Leung	62	Non-Executive Director and Member of Audit Committee
Allen Yau-Nam Cham	61	Non-Executive Director and Chairman of Audit Committee
Wing-Ki Hui	62	Non-Executive Director and Member of Audit Committee
Betty Lam	46	Chief Financial Officer
Lee Shu Kwan (S. K. Lee)	61	Director of Administration and Marketing for Electronic Operations
Tam Man Chi (M. C. Tam)	58	Director of Engineering and Manufacturing for Electronic Operations

Richard Lau. Mr. Lau served as Chief Executive Officer and Chairman of the Board of Directors of the Company and its predecessors since their inception in 1987 until February 2007, at which time he retired as Chief Executive Officer. Mr. Lau remains as Chairman of the Board.

Franki S. F. Tse. Mr. Tse joined Deswell in February 2007 at its Chief Executive Officer, bringing with him over 19 years experience in the tool-making, plastic injection and electronic service provider, or EPS, industry. From July 2005 until joining Deswell, he served as Vice President of Operations for Goodbaby Child Products Co. Ltd., a leading baby-products manufacturing company in Shanghai, China with approximately 15,000 workers. From May 2001 to June 2005 Mr. Tse served as Director of Marketing of Deswell s plastic subsidiary, Jetcrown Industrial (Dongguan) Ltd. From 1988 to 2000, Mr. Tse was in charge of the China Sales Business Division of Qualidux Industrial Co., Ltd., a group of companies engaged in original design and original equipment plastics manufacturing. Mr. Tse received his MBA in Business Finance from the University of Lincoln, United Kingdom in 2002.

C. P. Li. Mr. Li has served the Company as a Member of the Board of Directors and in various executive capacities with the Company and its predecessors since their inception in 1987. He became Secretary of the Company in February 1995 and Chief Financial Officer in May 1995, a position which he held until March 31, 2006. As Executive Director of Manufacturing and Administration for Plastic Operations, Mr. Li is in charge of the manufacturing and administrative operations for the Company s plastic products. Mr. Li received his Bachelor of Science degree from Chun Yan Institute College, Taiwan in 1967.

C. W. Leung. Mr. Leung has served the Company as a Member of the Board of Directors and in various executive capacities with the Company and its predecessors since their inception in 1987. As Executive Director of Engineering for Plastic Operations, Mr. Leung is in charge of the mold division and engineering for the Company s plastic manufacturing operations.

Hung-Hum Leung. Mr. Leung has been a non-executive director of the Company and member of the Audit Committee since December 1999. Mr. Leung has over 25 years of experience in the manufacture of electronic products. Mr. Leung was the founder of Sharp Brave Holdings Ltd., a Hong Kong public company listed on the Hong Kong Stock Exchange, and from 1991 to 1995 served as the Chairman of Sharp Brave Holdings Ltd. Since 1995, Mr. Leung has been an independent consultant to the electronics industry. He received his Bachelor of Science degree in Physics from the National Taiwan University in 1971.

Allen Yau-Nam Cham. Mr. Cham has been a non-executive director of the Company and member of the Audit Committee since August 2003. Mr. Cham has been the Managing Director and shareholder of Kwong Fat

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Hong (Securities) Limited since 1995. He has over 20 years of experience in the securities industry. He is a Certified General Accountant in Canada. He obtained his Bachelor of Science degree from St. Mary s University, Halifax, Canada, Bachelor of Engineering (Electrical) degree from Nova Scotia Technical College, Halifax, Canada and Master of Business Administration degree from University of British Columbia, Canada.

Wing-Ki Hui. Mr. Hui has been a non-executive director of the Company and member of the Audit Committee since October 2004. Since 1995 he has been the Operation Director of Tomorrow International Holdings Limited, a company listed on the Hong Kong Stock Exchange engaged in manufacturing of consumer electronics and printed circuit boards. Prior to serving in this capacity, Mr. Hui was Executive Director of Sharp Brave International Holdings Limited from 1991 to 1995 and Director of Sharp Brave Electronics Co., Ltd. from 1984 to 1995. Mr. Hui possesses over 20 years of experience in the electronic manufacturing industry, and is a graduate of South East Electronic College in Hong Kong.

Betty Lam joined the Company as Chief Financial Officer effective on August 1, 2008, succeeding Eliza Y. P Pang. Ms Lam has over 20 years experience in accountancy profession in various industries. Before joining Deswell, Ms. Lam served as Finance Director from August 2007 until July 2008, and as Financial Controller from March 2000 to July 2007, for Paxar (China) Limited, a multinational corporation manufacturing packaging items, hang tags, woven and paper labels for the garment industries. During the fifteen years preceding her tenure at Paxar, Ms. Lam served in the finance departments of other enterprises, including over three years with Deloitte Haskins & Sells, an international public accounting firm that was one of the predecessors of Deloitte & Touche (Deloitte, Touche Tohmatsu in Asia). Ms Lam received her Master of Business in Accounting and Finance from the University of Technology, Sydney in 1996 and her Professional Diploma in Accountancy from the Hong Kong Polytechnic in 1985.

S. K. Lee. Mr. Lee has served as Director of Administration and Marketing for Electronic Operations since the Company acquired its majority interest in Kwanasia, Integrated s predecessor, in 1992 and has served as the Chief Executive Officer of Kwanasia and Integrated since Kwanasia s inception in 1986. As Director of Administration and Marketing for Electronic Operations, Mr. Lee is in charge of the Company s day-to-day administrative and marketing operations for electronic products. Mr. Lee received his Bachelor of Science degree in Electronic Engineering from National Taiwan University in 1967.

M. C. Tam. Mr. Tam has served as Director of Engineering and Manufacturing for Electronic Operations since the Company acquired its majority interest in Kwanasia, Integrated s predecessor, in 1992 and has served in a similar capacity for Kwanasia and Integrated since Kwanasia s inception in 1986. As Director of Engineering and Manufacturing for Electronic Operations, Mr. Tam is in charge of the Company s day-to-day contract manufacturing activities for electronic products. Mr. Tam received his Bachelor of Science degree with a major in physics and minor in electronics from the Chinese University of Hong Kong in 1973.

No family relationship exists among any of the named directors, executive officers or key employees. No arrangement or understanding exists between any director or officer and any other persons pursuant to which any director or executive officer was elected as a director or executive officer of the Company.

Compensation of Directors and Executive Officers

Executive Officers

The aggregate amount of compensation (including non-cash benefits) paid by the Company and its subsidiaries during the year ended March 31, 2008 to all directors and executive officers as a group for services in all capacities was approximately $2,449,650. This excludes amounts paid by the Company or its subsidiaries as dividends to shareholders during the year ended March 31, 2008.

Directors

Effective August 1, 2003, directors who are not employees of the Company or any of its subsidiaries are paid $2,000 per month for services as a director, and are reimbursed for all reasonable expenses incurred in connection with services as a director and member of Board committees. The Board has determined that Messrs. Hung-Hum Leung, Allen Yau-Nam Cham, Wing-Ki Hui are independent within the meaning of Rule 4200 of the Nasdaq Marketplace Rules.

Board Practices

The directors of the Company are elected at its annual meeting of shareholders and serve until their successors take office or until their death, resignation or removal. The executive officers serve at the pleasure of the Board of Directors of the Company.

Audit Committee

The Audit Committee meets from time to time to review the financial statements and matters relating to the audit and has full access to management and the Company s auditors in this regard. The Audit Committee recommends the engagement or discharge of the Company s independent accountants, consults on the adequacy of the Company s internal controls and accounting procedures and reviews and approves financial statements and reports. Deswell s audit committee consists of Messrs. Hung-Hum Leung, Allen Yau-Nam Cham and Wing-Ki Hui, each of whom is an independent director within the meaning of that term under the Nasdaq Stock Market Rules. Mr. Allen Yau-Nam Cham currently acts as the Chairman of the Audit Committee.

Other Committees; Nasdaq Compliance

In August 2005, Deswell determined to disband and no longer have either a compensation committee or a nominating committee as the law of the British Virgin Islands, Deswell s place of organization, and Deswell s Memorandum and Articles of Association do not require it to have such committees. Although such committees, consisting of independent directors as defined by the Nasdaq Marketplace Rules, are required of domestic companies having securities included on The Nasdaq Stock Market, they are not required of foreign private issuers such as Deswell if such issuers follow their home country practice. In addition to not having a compensation committee or a nominating committee consisting of independent directors, Deswell also follows home country practice of not having nominees to its board selected or recommended by a majority of its independent directors; a majority of its Board of Directors are not independent directors within the definition of independent director in the Nasdaq Marketplace Rules and Deswell s independent directors do not meet in executive session.

Employees

At March 31, 2008, the Company employed 5,978 persons on a full-time basis, of which 9 were located in Macao and 5,969 located in and travel to and from China. Of the Company s employees 3,926 and 2,052 were engaged in plastic injection molding manufacturing and contract electronic manufacturing, metal molds and parts manufacturing, respectively, at March 31, 2008. The Company has not experienced significant labor stoppages. Management believes that relations with the Company s employees are satisfactory.

Share Ownership

Share Ownership of Directors and Senior Management

For information concerning the beneficial ownership of the Company s common shares by Directors and Senior Management and major shareholders, see Item 7 of this Report.

Employee Stock Option Plans

In 1995, the Company adopted its 1995 Stock Option Plan permitting the Company to grant options to purchase up to 1,012,500 common shares to employees, officers, directors and consultants of the Company. On September 29, 1997, the Company s Board of Directors and shareholders approved an increase of 549,000 shares in the number of shares that can be optioned and sold under the Option Plan bringing to a total of 1,561,500 shares the number of common shares that can be optioned and sold under the 1995 Stock Option Plan.

On August 15, 2001 the Board approved the adoption of the 2001 Stock Option Plan permitting the Company to grant options to purchase up to an additional 1,125,000 common shares to employees, officers, directors and consultants of the Company. On January 7, 2002 shareholders approved the 2001 plan.

On August 20, 2003, the Board approved the adoption of the 2003 Stock Option Plan permitting the Company to grant options to purchase up to an additional 900,000 common shares to employees, officers, directors, consultants and advisors of the Company. On September 30, 2003 shareholders approved the 2003 plan. On August 1, 2005, the Company s Board of Directors, subject to shareholder approval, approved amendments to the 2003 Stock Option to increase by 500,000 shares in the number of shares that can be optioned and sold under the 2003 Stock Option Plan, bringing to a total of 1,400,000 shares the number of common shares that can be optioned and sold under the 2003 Stock Option Plan. The Company s shareholders approved this amendment at the Company s Annual Shareholders

Meeting held on September 19, 2005.

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On August 17, 2007, the Company s Board of Directors, subject to shareholder approval, approved amendments to the 2003 Stock Option to increase by 400,000 shares in the number of shares that can be optioned and sold under the 2003 Stock Option Plan, bringing to a total of 1,800,000 shares the number of common shares that can be optioned and sold under the 2003 Stock Option Plan. The Company s shareholders approved this amendment at the Company s Annual Shareholders Meeting held on October 9, 2007.

The Company s option plans are administered by the Board of Directors, which determines the terms of options granted, including the exercise price, the number of shares subject to the option and the option s exercisability. The exercise price of all options granted under the option plans must be at least equal to the fair market value of such shares on the date of grant. The maximum term of options granted under the option plans is 10 years.

At June 30, 2008, options to purchase an aggregate of 4,296,500 shares had been granted under the option plans, options to purchase an aggregate of 1,119,000 common shares were outstanding and options to purchase 190,000 common shares were available for future grant under the option plans.

ITEM 7. MAJOR SHAREHOLDERS AND RELATED PARTY TRANSACTIONS

Major Shareholders

The Company is not directly owned or controlled by another corporation or by any foreign government. The following table sets forth, as of June 30, 2008, the beneficial ownership of the Company s common shares by each person known by the Company to beneficially own 5% or more of the common shares of the Company and by each of the Directors and Senior Management of the Company who beneficially own in excess of one percent of the Company s common shares.

	Number of shares beneficially owned (1)	
Name of beneficial owner or identity of group	**Amount**	**Percent**
Wellington Management Company, LLP (2)	1,795,762	11.4%
Richard Lau (3)	1,641,545	10.2%
C. P. Li (4)	1,446,250	9.0%
Royce & Associates, Inc. (5)	1,364,969	8.6%
C. W. Leung (6)	1,335,000	8.4%
FMR Corp./ Edward C. Johnson 3d (7)	867,268	5.5%
M. C. Tam	362,225	2.3%
S. K. Lee	331,040	2.1%
Franki S. K. Tse	*	*
Betty Lam (8)		
Eliza Y. P. Pang(9)	*	*
Hung-Hum Leung	Nil	Nil
Allen Yau-Nam Cham	Nil	Nil
Wing-Ki Hui	Nil	Nil

* Less than 1%.

(1) Based on 15,790,810 shares outstanding on June 30, 2008. However, in accordance with Rule 13d-3(d)(1)

under the Securities Exchange Act of 1934, shares not outstanding but which are the subject of currently exercisable options have been considered outstanding for the purpose of computing the percentage of outstanding shares owned by the listed person holding such options, but are not considered outstanding for the purpose of computing the percentage of shares owned by any of the other listed persons.

(2) Based on Amendment No. 5 to Schedule 13G filed with the SEC on February 14, 2008.

(3) Consists of 1,346,545 held of record by Mr. Lau and options to purchase 295,000 shares granted to Mr. Lau under the Company s stock option plans. Mr. Lau s options are

exercisable at a weighted average exercise price of $10.41 per share until January 20, 2018.

(4) Consists of 1,151,250 held of record by Mr. Li and options to purchase 295,000 shares granted to Mr. Li under the Company s stock option plans. Mr. Li s options are exercisable at a weighted average exercise price of $11.52 per share until January 20, 2018.

(5) Based on Amendment No. 7 to a Schedule 13G filed with the SEC on February 1, 2008.

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(6) Consists of 1,140,000 held of record by Mr. Leung and options to purchase 195,000 shares granted to Mr. Leung under the Company s stock option plans. Mr. Leung s options are exercisable at a weighted average exercise price of $11.52 per share until January 20, 2018.

(7) Based on Amendment No. 5 to a Schedule 13G filed with the SEC on February 14, 2008.

(8) Ms. Lam joined the Company as its Chief Financial Officer effective August 1, 2008.

(9) Ms. Pang resigned as Chief Financial Officer effective on July 31, 2008.

Change in the Percentage Ownership Held by Major Shareholders

The following table reflects the percentage ownership of Deswell s common shares by its major shareholders during the past three years:

Percentage Ownership at June 30,[1]

	2006	2007	2008
Wellington Management Company, LLP	9.6%	10.6%	11.4%
Richard Lau[(2)]	26.0%	25.3%	10.2%
C. P. Li[(2)]	25.2%	24.0%	9.0%
Royce & Associates, Inc.	10.4%	8.1%	8.6%
C. W. Leung[(2)]	24.3%	24.1%	8.4%
FMR Corp./ Edward C. Johnson 3d/ Abigail P. Johnson	6.3%	6.0%	5.5%
Leesha Holdings Ltd.[(2)]	23.1%	22.8%	
Micropower Enterprises Limited	7.7%	7.6%	

(1) Based on 14,923,730, 15,143,730 and 15,790,810 shares outstanding on June 30, 2006, 2007 and 2008, respectively. However, in accordance with Rule 13d-3(d)(1) under the Securities Exchange Act of 1934, common shares not outstanding but which are the subject of currently exercisable options have been considered outstanding for the purpose of computing the percentage of outstanding common shares owned by the listed person holding such options, but are not considered outstanding for the purpose of computing the percentage of common shares owned by any of

the other listed persons.

(2) Leesha Holding Ltd. is an investment holding company organized as an International Business Company under the laws of the British Virgin Islands. Messrs. Lau, Li and Leung, who are its directors, wholly own Leesha in equal shares. Among other investments, Leesha owned 3,453,750 common shares of Deswell, which were transferred to Leesha by Messrs. Lau, Li and Leung shortly after Deswell s initial public offering in 1996. On September 14, 2007, Leesha declared a dividend to its shareholders of all 3,453,750 common shares of Deswell, distributing 1,151,250 shares of the Company to each of Messrs. Lau, Li and Leung. Accordingly, effective when

Leesha distributed its Deswell shares, the beneficial ownership of Leesha in Deswell, and the attribution of such ownership to each of Messrs. Lau, Li and Leung, as Leesha s directors and principal shareholders, terminated.

All of the holders of the Company s common shares (including Deswell s major shareholders) have equal voting rights with respect to the common shares held. As of June 30, 2008, approximately 26 holders of record, who, management believes, held for more than 3,000 beneficial owners, held Deswell s common shares. According to information supplied to the Company by its transfer agent, at June 30, 2008, 18 holders of record with addresses in the United States held approximately 11.4 million of our outstanding common shares.

Related Party Transactions

In August 2007, Deswell acquired the remaining 24% minority interest of Integrated International Limited (Integrated), the holding company for Deswell s electronics and metallic subsidiaries. The aggregate purchase price for the 24% interest was $6,734,378, consisting of (a) 632,080 common shares of Deswell (based on the closing price per share of Deswell s shares on August 17, 2008) and (b) a cash payment of HK$3,234,180 (approximately US$413,578) to Messrs. S. K. Lee and M. C. Tam, the minority shareholders of Integrated and Deswell s Director of Administration and Marketing for Electronic Operations,, our Director of Engineering and Manufacturing for Electronic Operations, respectively, and executive officers of Deswell. Messrs. Lee and Tam agreed with respect to the shares issued to them by Deswell that for a period of 15 months from the closing of this transaction not to offer to sell, contract to sell, or otherwise sell, dispose of, loan, pledge or grant any rights with respect to any of the Deswell shares they acquired for their Integrated interest or grant any options or warrants to purchase any of those shares or any securities convertible into or exchangeable for those shares otherwise than as a bona fide gift or gifts, provided the donee or donees thereof agree in writing to be bound by the lockup restriction, or (ii) with the prior written consent of Deswell. The lockup period expires in November 2009.

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During the years ended March 31, 2007 and 2008, while Intergrated was a 76 percent-owned subsidiary of Deswell, Integrated made distributions to its shareholders, including Deswell, aggregating approximately $2,425,000 and $nil, with Messrs. Tam and Lee s share of these distributions (which were divided between them equally) amounting to $582,000 respectively.

Since Deswell completed its initial public offering in the United States, it has been Deswell s policy that all transactions between Deswell and any interested director or executive officer be approved by a majority of the disinterested directors and be on terms that are no more favorable than would be available from an independent third party.

ITEM 8. FINANCIAL INFORMATION

Financial Statements

Our Consolidated Financial Statements are set forth under Item 18 Financial Statements.

Legal Proceedings

The Company is not involved in any material legal proceedings.

Exports Sales

Information regarding our export sales is provided in Item 4 Information on the Company Business Overview Customers and Marketing.

Dividend Policy

Dividends paid under Hong Kong law are tax free to the recipient. While the Company had paid dividends to its shareholders prior to its IPO, it discontinued payment of dividends after the IPO until July 1996, when Deswell announced that it planned to pay cash dividends semi-annually. Commencing with the fiscal year ended March 31, 2003, the Company announced it would pay cash dividends on a quarterly basis based upon the Company s quarterly results. Under this dividend policy, the Company declared and paid dividends during the year ended March 31,

2006 aggregating $9,400,000, $2,535,000 of which was based on results for the last quarter of the year ended March 31, 2005 and $6,865,000 of which was based on results for the first three quarters of the year ended March 31, 2006;

2007 aggregating $9,720,000, $2,089,000 of which was based on results for the last quarter of the year ended March 31, 2006 and $7,631,000 of which was based on results for the first three quarters of the year ended March 31, 2007; and

2008 aggregating $9,523,000, $2,574,000 of which was based on results for the last quarter of the year ended March 31, 2007 and $6,949,000 of which was based on results for the first three quarters of the year ended March 31, 2008.

The Company currently plans to continue its quarterly dividend policy as announced, but such plans and policy for future dividends consist of 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. Whether future dividends will be declared will depend upon the Company s future growth and earnings, of which there can be no assurance, and the Company s cash flow needs for future development, which growth, earning or cash flow needs may be adversely affected by one or more of the factors discussed in Item 3. Key Information Risk Factors. Accordingly, there can be no assurance that future cash dividends on the Company s common shares will be declared, what the amounts of such dividends will be or whether such dividends, once declared for a specific period will continue for any future period or at all.

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ITEM 9. THE OFFER AND LISTING

The Company s shares are traded exclusively on the Nasdaq Global Market (before July 4, 2006, known as the Nasdaq National Market) under the symbol DSWL .

The following table sets forth the high and low sale prices per share as reported by The Nasdaq Global Market (the Nasdaq National Market before July 4, 2006) for each of the years in the five-year period ended March 31, 2008 (adjusted for per share prices before April 2005, for the Company s three-for-two stock split effected in March 2005):

Year Ended March 31,	High	Low
2008	$ 13.04	$ 6.00
2007	12.50	8.10
2006	16.48	9.00
2005	18.167	12.867
2004	20.40	10.43

The following table sets forth the high and low sale prices per share of Deswell s shares as reported by the Nasdaq Global Market (the Nasdaq National Market before July 4, 2006) during each of the quarters in the two-year period ended March 31, 2008).

Quarter ended	High	Low
March 31, 2008	$ 6.96	$ 6.07
December 31, 2007	7.47	6.00
September 30, 2007	10.13	9.24
June 30, 2007	13.04	10.92
March 31, 2007	12.50	11.21
December 31, 2006	11.70	10.46
September 30, 2006	10.96	8.40
June 30, 2006	9.90	8.10

The following table sets forth the high and low sale prices per share of Deswell shares as reported by The Nasdaq Global Market during each of the six months ended June 30, 2008.

Month ended	High	Low
June 30, 2008	$7.41	$5.60
May 31, 2008	7.65	6.35
April 30, 2008	6.52	5.98
March 31, 2008	6.96	6.07
February 29, 2008	6.97	5.90
January 31, 2008	6.19	5.39

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ITEM 10. ADDITIONAL INFORMATION

Share Capital

Not applicable.

Memorandum and Articles of Association

In December 2007, we filed with the Registrar of Corporate Affairs of the British Virgin Islands, the jurisdiction of registrant s organization, an amended and restated Memorandum and Articles of Associations (collectively the 2007 Charter), the instruments governing a company organized under the law of the British Virgin Islands, which are comparable in purpose and effect to certificates or articles of incorporation and bylaws of corporations organized in a state of the United States. The 2007 Charter, which became effective on December 13, 2007, amended and restated our Memorandum and Articles of Association, as amended that were in effect prior to the 2007 Charter. The purpose of adopting the 2007 Charter was to:

(a) make our shares eligible for a direct registration system operated by a securities depository in accordance with NASDAQ Marketplace Rule 4350(1) that became effective on January 1, 2008 as to companies, like us, having had equity securities listed on the Nasdaq Stock Market prior to January 1, 2007;

(b) make various consequential amendments to our Memorandum and Articles of Association in accordance with the advice from our US and BVI counsel so as to make them (a) consistent with the BVI Business Company s Act, 2004, as amended (the Act), the Act having come into force on January 1, 2004 superseding in certain respects the International Business Companies Act, 1984, the relevant legislation which had previously governed us and (b) make conforming changes resulting from the transition of the Nasdaq Stock Market s operations on August 1, 2006 to that of a national securities exchange in the United States;

(c) continue certain special provisions of our Memorandum and Articles of Association that we adopted in preparation for our initial public offering of securities in the United States; and

(d) provide recognition of, and assure compliance with, certain laws, rules and regulations of the United States applicable to us, including the Sarbanes-Oxley Act of 2002, and the Marketplace Rules of the Nasdaq Stock Market.

Under our 2007 Charter, holders of our shares

- Continue to be entitled to one vote for each whole share on all matters to be voted upon by shareholders, including the election of directors;
- Continue not to have cumulative voting rights in the election of directors; and
- Continue to be entitled to receive dividends if and when declared by our board of directors out of funds legally available under British Virgin Islands law.

The 2007 Charter did not change that

- all of common shares are equal to each other with respect to liquidation and dividend rights;
- in the event of our liquidation, all assets available for distribution to the holders of our common shares are distributable among them according to their respective holdings; or
- holders of our common shares have no preemptive rights to purchase any additional, unissued common shares.

Objects and Purposes

Our objects and purposes are described in Clause 5 of our Memorandum of Association and are generally to engage in any act or activity that is not prohibited under the laws of the British Virgin Islands.

Directors

Our Articles of Association (Regulation 12.4) provides that except as otherwise provided in the BVI Business Companies Act, 2004 (No. 16 of 2004) the British Virgin Islands corporate law that governs BVI companies like Deswell no agreement or transaction between the Company and one or more of its directors or any person in which any director has a financial interest or to whom any director is related, including as a director of that other person, is void or voidable for this reason only or by reason only that the director is present at the meeting of directors or at the meeting of the committee of directors that approves the agreement or transaction or that the vote or consent of the director is counted for that purpose if the material facts of the interest of each director in the agreement or transaction and his interest in or relationship to any other party to the agreement or transaction are disclosed in good faith or are known by the other directors and such agreement or transaction has been approved by the irrevocable vote of a majority of the Company s directors, including at least, one Independent Director. In addition, the favorable vote of a majority of the directors, including at least one Independent Director, shall be required to approve any transaction or agreement between the Company and any officer of the Company or any person or entity holding 10 percent or more of the outstanding Shares.

Our Articles of Association (Regulation 7.11) provide that the directors may by a resolution of directors, fix the emoluments of directors with respect to services to be rendered in any capacity to the Company.

British Virgin Islands law and our Articles of Association provide that the management of the business and the control of Deswell shall be vested in the directors, who in addition to the powers and authorities expressly conferred by the Articles of Association, may also exercise all such powers, and do all such acts and things, as may be done by Deswell and are not by the Articles of Association or British Virgin Islands law expressly dir