BANCORP RHODE ISLAND INC
Form 10-K
March 16, 2010

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.
FORM 10-K
(Annual Report Under Section 13 of the Securities Exchange Act of 1934)
For the fiscal year ended December 31, 2009
Commission File No. 001-16101
BANCORP RHODE ISLAND, INC.
(Exact Name of Registrant as Specified in Its Charter)

Rhode Island	05-0509802
(State or Other Jurisdiction of Incorporation or Organization)	(IRS Employer Identification No.)

ONE TURKS HEAD PLACE, PROVIDENCE, RI 02903
(Address of Principal Executive Offices)
(401) 456-5000
(Issuer s Telephone Number, Including Area Code)
Securities registered pursuant to Section 12(b) of the Act: None
Securities registered pursuant to Section 12(g) of the Act:
Common Stock, par value $0.01 per share
(Title of Class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o No þ
Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes o No þ
Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes þ No o
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes o No o
Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant s knowledge, in definitive proxy or information statement incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. þ
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer o	Accelerated filer þ	Non-accelerated filer o	Smaller reporting company o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes o No þ
As of June 30, 2009, the aggregate market value of the voting common equity of the Registrant held by non-affiliates of the Registrant, based on the closing price on the Nasdaq Global Select Market SM was $72,380,323.

As of February 28, 2010, there were 4,617,594 shares of common stock (par value $0.01 per share) of the Registrant issued and outstanding.

Documents incorporated by reference:

Portions of Bancorp Rhode Island s Definitive Proxy Statement for the 2010 Annual Meeting of Shareholders are incorporated by reference into Parts II and III of this Form 10-K.

See pages 57 to 59 for the exhibit index.

Bancorp Rhode Island, Inc.
Annual Report on Form 10-K
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PART I

SPECIAL NOTE REGARDING FORWARD LOOKING STATEMENTS

We make certain forward looking statements in this Annual Report on Form 10-K and in other documents that we incorporate by reference into this report that are based upon our current expectations and projections about future events. We intend these forward looking statements to be covered by the safe harbor provisions for forward looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, and we are including this statement for purposes of these safe harbor provisions. You can identify these statements by reference to a future period or periods by our use of the words estimate, project, may, believe, intend, anticipate, plan, seek, expect and similar terms or variatio
These forward looking statements include:

- statements of our goals, intentions and expectations;
- statements regarding our business plans and prospects and growth and operating strategies;
- statements regarding the quality of our products and our loan and investment portfolios; and
- estimates of our risks and future costs and benefits.

Actual results may differ materially from those set forth in forward looking statements as a result of these and other risks and uncertainties, including those detailed herein under Item 1A, Risk Factors , and from time to time in other filings with the Federal Deposit Insurance Corporation (FDIC) and the Securities and Exchange Commission (SEC). We have included important factors in the cautionary statements included or incorporated in this document, particularly under Item 1A, Risk Factors , that we believe could cause actual results or events to differ materially from the forward looking statements that we make. Our forward looking statements do not reflect the potential impact of any future acquisitions, mergers, dispositions, joint ventures or investments we may make. We do not assume any obligation to update any forward looking statements.

ITEM 1. BUSINESS

Introduction

Bancorp Rhode Island, Inc. (we or the Company), a Rhode Island corporation, is the holding company for Bank Rhode Island (the Bank). The Company has no significant assets other than the common stock of the Bank. For this reason, substantially all of the discussion in this document relates to the operations of the Bank and its wholly-owned subsidiaries, which include BRI Investment Corp. (a Rhode Island passive investment company), Macrolease Corporation (an equipment financing company), Acorn Insurance Agency, Inc. (a licensed insurance agency) and BRI Realty Corp. (a real estate holding company).

The Bank is a commercial bank chartered as a financial institution in the State of Rhode Island and was formed in 1996 as a result of the acquisition of certain assets and liabilities divested in connection with the merger of Fleet Financial Group, Inc. and Shawmut National Corporation. Headquartered in Providence, Rhode Island, the Bank conducts business through 16 full-service branches, with 12 located in Providence County, 3 located in Kent County and 1 located in Washington County. The Bank augments its branch network through online banking services and automatic teller machines (ATMs), both owned and leased, located throughout Rhode Island.

The Bank provides a community banking alternative in the greater Providence market which is dominated by three large banking institutions, two national and one regional. Based on total deposits as of June 30, 2009 (excluding one bank that draws its deposits primarily from the internet), the Bank is the fifth largest bank in Rhode Island and the only mid-sized commercially focused bank headquartered in Providence, the State s capital. The Bank offers its customers a wide range of business, commercial real estate, consumer and residential loans, commercial leases, deposit products, nondeposit investment products, cash management and online banking services, private banking and other banking products and services designed to meet the financial needs of individuals and small- to mid-sized businesses. As a full-service community bank, the Bank seeks to differentiate itself from its large bank competitors through superior personal service, responsiveness and local decision-making. The Bank s deposits are insured by the FDIC, subject to regulatory limits.

The Company s headquarters and executive management are located at One Turks Head Place, Providence, Rhode Island 02903 and its telephone number is (401) 456-5000. The Bank also maintains an internet website at http://www.bankri.com.

The Company makes available free of charge through its website at http://www.bankri.com all reports it electronically files with, or furnishes to, the SEC, including its Annual Report on Form 10-K, Quarterly Reports on Form 10-Q and Current Reports on Form 8-K, as well as any amendments to those reports, as soon as reasonably practicable after those documents are filed with, or furnished to, the SEC. These filings are also accessible on the SEC s website at http://www.sec.gov.

Overview

The Company, through the Bank, concentrates its business efforts in three main areas. First, the Bank emphasizes commercial lending. The high concentration of small to mid-size businesses in the Bank s predominately urban franchise makes deployment of funds in the commercial lending area practicable. Moreover, the Bank believes it can attract commercial customers from larger competitors through a higher level of service and its ability to set policies and procedures, as well as make decisions, locally. Second, the Bank has sought to grow its demand deposit, savings and other transaction-based accounts, collectively referred to as core deposits. The Bank has stressed development of full relationships with customers, including its commercial customers, who tend to be more relationship oriented than those who are seeking stand-alone or single transaction products. Third, the Bank seeks to leverage its knowledge and customer base to develop related lines of business. Since inception, the Bank has grown its consumer loan portfolio, acquired an equipment financing company, added sales of investment products and begun a private banking group.

In March 2009, the Bank marked its thirteenth year in business. During the past thirteen years, the Company has grown its assets, deposits and customer base significantly and has expanded the depth and breadth of its management team and staff. Also, the Bank has substantially enlarged and improved its branch network and enhanced its operating systems and infrastructure. The Bank was named the U.S. Small Business Administration s (SBA) No. 1 lender in Rhode Island as of the SBA s September 30, 2009 fiscal year end.

The Company continues to transition from a young, high growth *de novo* bank into a more mature institution, which seeks to better leverage the footprint it has built and investments it has made. The Company continued to achieve double-digit commercial loan and lease growth in 2009, with commercial outstandings increasing 11.2% from $658.4 million at the prior year-end to $732.4 million at December 31, 2009. Residential mortgages and consumer loans declined compared to 2008 as the Company continued its strategic conversion to a more commercially-oriented balance sheet.

During the year, the Company added $9.9 million to its allowance for loan and lease losses. The provision exceeded net charge-offs by $1.9 million. The increased provision served to strengthen the ratio of the allowance to loans and leases to 1.49 percent at December 31, 2009, up from 1.36 percent at December 31, 2008. Nonperforming loans and leases at December 31, 2009 totaled $18.3 million, up from $14.4 million a year ago. As a percentage of total loans and leases, nonperforming loans and leases ended 2009 at 1.65 percent, compared to 1.33 percent at the end of the year in 2008. The Company believes its net charge-offs and nonperforming loan and lease ratio continue to compare favorably to its peer group, reflecting a culture of prudence and diligence in its risk management practices and business approach.

Competition for deposits remained strong in the Bank s primary market area. In 2009, the Bank s core deposits increased by $92.4 million, or 14.9%, which was offset by a decrease in certificate of deposit accounts of $36.3 million, or 8.6%. Overall, the Bank increased its total deposits by $56.1 million, or 5.4%, year-over-year. The increase in total deposits reflects the Bank s strategic efforts to expand its commercial deposit relationships with existing and new customers and sales of retail deposit products through its branch network and in conjunction with consumer lending programs.

The Bank s North Kingstown, East Greenwich, Lincoln and Pawtucket branches all continue to make progress. Each of the branches, opened from 2004 to 2007, realized deposit growth in 2009. In the aggregate, the new branches increased their deposits by $15.8 million, or 14.3%, to $110.3 million during 2009. The Lincoln branch experienced the largest increase in deposit balances ($6.2 million, or 20.9%, year over year) while the North Kingston branch, whose deposits aggregated $48.9 million, had the least deposit growth of the new branches ($2.8 million, or 6.0%,

compared to December 31, 2008).

The Company continued to proactively manage its balance sheet, resulting in a 4 basis point increase year over year despite declining rates of interest-earning assets. During 2009, the Company realized $61,000 in gains on sales of mortgage-backed securities. Additionally, the Company maintained its quarterly dividend of $0.17 per share throughout 2009.

Noninterest income declined $1.4 million, or 13.6%, to $9.2 million in 2009 as compared to 2008. Deposit service charges continue to account for over half of the Company s noninterest income, slightly increasing to 58.7% in 2009 from 53.8% in 2008.

While the Company s efficiency ratio increased from 67.68% in 2008 to 68.76% in 2009, management s focus on expense control limited the noninterest expense increase to only $1.6 million, or 4.3%, despite increases in FDIC insurance costs of $1.8 million.

During 2009, the Company continued to add breadth and depth to its senior management team with the addition of in-house counsel and senior vice presidents responsible for loan origination and retail banking. The Company also expanded its business development team after successfully adding a position in 2008. The Company believes that these management changes will improve its overall administration as well as promote business development.

Capital Strength and Exit from the U.S. Treasury s Capital Purchase Program

In December 2008, the Company became a participant in the U.S. Treasury Department s Capital Purchase Program (CPP) and issued the U.S. Treasury 30,000 shares of Fixed Rate Cumulative Perpetual Preferred Stock, Series A, with a liquidation value of $1,000 per share and a warrant to purchase 192,967 shares of common stock at an exercise price of $23.32 per share.

On August 5, 2009, the Company repurchased the preferred stock issued to the U.S. Treasury for $30.0 million plus accrued dividends through the date of repurchase of $333,000 and exited the CPP. The repurchase of the preferred stock resulted in the recognition of $1.3 million in prepayment charges on the discount associated with its issuance. On September 30, 2009, the Company repurchased the warrant for $1.4 million.

While the Company was not required to raise additional capital in order to repay the CPP funds, the Company s Board of Directors (the Board) believed it was prudent to assure access to capital on reasonable terms should economic conditions continue or worsen. Also, a commitment for additional capital would provide the Company with increased flexibility in responding to market developments. For these reasons, the Company entered into a Standby Commitment Letter Agreement on August 5, 2009 with a trust of which Malcolm G. Chace, the Company s Chairman of the Board and owner of more than 10% of the Company s outstanding common stock, is a trustee and beneficiary. Pursuant to this commitment, the Company will have the right, exercisable at any time through February 5, 2011, to require the Chace Trust to purchase up to $8.0 million of trust preferred securities to be issued by a trust subsidiary of the Company. The terms of the commitment and trust preferred securities are more fully described under Management s Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources Capital Resources. As consideration for the commitment, the Company paid a $320,000 commitment fee, representing 4% of the maximum commitment.

As of December 31, 2009, the Company and the Bank remained well-capitalized by the standards established by the Board of Governors of the Federal Reserve System (FRB) and FDIC. The Company s Tier 1 Capital Ratio, Tier 1 Risk-Based Capital Ratio and Total Risk-Based Capital Ratio were 7.65%, 10.71% and 11.97%, respectively, as of December 31, 2009. The Bank s Tier 1 Capital Ratio, Tier 1 Risk-Based Capital Ratio and Total Risk-Based Capital Ratio were 7.54%, 10.55% and 11.81%, respectively, as of December 31, 2009. These capital ratios and requirements are further discussed at *Regulatory Capital Requirements* on pages 11 and 12. The Company s tangible common equity ratios of 6.87% and 7.15% at December 31, 2009 and 2008, respectively, also demonstrate the Company s capital strength.

Lending Activities

The Bank s business strategy has been to grow its commercial and consumer loan and lease portfolios while allowing its residential mortgage loan portfolio to decline gradually as a percent of total loans and leases. The Bank has allocated substantial resources to its commercial and consumer lending functions to facilitate and promote such growth. From December 31, 2004 through December 31, 2009, commercial loan and lease outstandings have increased $329.6 million, or 81.8%, and represent 65.9% of total loans and leases at December 31, 2009 compared to 45.4% at December 31, 2004. Consumer loan outstandings have increased $38.8 million, or 23.2%, from December 31, 2004 through December 31, 2009, but have remained fairly consistent as a percentage of total loans and leases. Consumer loans decreased slightly from 18.9% of total loans and leases at December 31, 2004 to 18.5% of total loans and leases at December 31, 2009. Meanwhile, residential mortgage loans decreased from 35.7% of total loans and leases at December 31, 2004 to 15.6% of total loans and leases at December 31, 2009.

The Bank offers a variety of loan facilities to serve both commercial and consumer borrowers primarily within the State of Rhode Island and nearby areas of Massachusetts. Approximately 66% of Rhode Island businesses, 76% of

Rhode Island jobs and 76% of the Rhode Island population are located in Providence and Kent Counties. More than 98% of Rhode Island businesses have fewer than 100 employees. The Bank believes the financing needs of these businesses generally match the Bank s lending profile and that the Bank s branches are well positioned to facilitate the generation of loans from this customer base.

The Bank s commercial lending function is organized into two groups. The business lending group originates business loans and leases, often referred to as commercial and industrial loans and leases, including owner-occupied commercial real estate loans, term loans, revolving lines of credit and equipment leases (through the Bank s subsidiary, Macrolease). The commercial real estate group originates nonowner-occupied commercial real estate, multi-family residential real estate and construction loans.

The Bank s branch network and business development team also play a role in business lending relationships under $1.0 million. Underwriting, processing and monitoring the bulk of business credit relationships under $1.0 million are supported by the Bank s lending services group. The lending services group also processes and monitors consumer loans. The creation of the lending services group has enhanced the Bank s ability to reach more borrowers with the same number of personnel as well as achieve more efficient processing and monitoring of these credits.

The Bank also satisfies a variety of consumer credit needs by providing home equity term loans, home equity lines of credit, direct automobile loans, savings secured loans and personal loans, in addition to residential mortgage loans.

The Bank has tiered lending authorities. Certain senior executives have lending approval authority up to $3.0 million. Extensions of credit to a customer relationship greater than established authority levels (up to the Bank s house lending limit of $10.0 million) require the approval of the Credit Committee, which consists of members of the Bank s senior management and one outside director. Exceptions to the Bank s house lending limit require the approval of a committee of the Board of Directors. Other officers have limited lending authorities that can be exercised subject to lending policy guidelines to facilitate production volume and process flow.

The Bank issues loan commitments to prospective borrowers subject to various conditions. Commitments generally are issued in conjunction with commercial loans and residential mortgage loans and typically are for periods up to 90 days. The proportion of the total value of commitments derived from any particular category of loan varies from time to time and depends upon market conditions. At December 31, 2009, the Bank had $219.7 million of aggregate commitments outstanding to fund loans and leases.

Overall, loans and leases produced total interest income of $59.8 million, or 79.4% of total interest and dividend income, in 2009 and $63.0 million, or 78.5% of total interest and dividend income, during 2008.

Commercial Real Estate and Multi-Family Loans The Bank originates loans secured by mortgages on owner-occupied and nonowner-occupied commercial and multi-family residential properties. At December 31, 2009, owner-occupied commercial real estate loans totaled $167.9 million, or 15.1% of the total loan and lease portfolio. Many of these customers have other commercial borrowing relationships with the Bank, as the Bank finances their other business needs. Generally these customer relationships are handled in the Bank s business lending group. Nonowner-occupied commercial real estate loans totaled $170.1 million, or 15.3% of the total loan and lease portfolio, and multi-family residential loans totaled $66.4 million, or 6.0% of the total loan and lease portfolio, and are generally handled in the Bank s commercial real estate group. These real estate secured commercial loans are offered as both fixed and adjustable rate products. The Bank typically charges higher interest rates on these loans than those charged on adjustable rate loans secured by one- to four-family residential units. Additionally, the Bank may charge origination fees on these loans.

The Bank s underwriting practices for permanent commercial real estate and multi-family residential loans are intended to assure that the property securing these loans will generate a positive cash flow after operating expenses and debt service payments. The Bank requires appraisals before making a loan and generally requires the personal guarantee of the borrower. Permanent loans on commercial real estate and multi-family properties generally are made at a loan-to-value ratio of no more than 80%.

Loans secured by nonowner-occupied commercial real estate and multi-family properties involve greater risks than owner-occupied properties because repayment generally depends on the rental income generated by the property. In addition, because the payment experience on loans secured by nonowner-occupied properties is often dependent on successful operation and management of the property, repayment of the loan is usually more subject to adverse conditions in the real estate market or the general economy than is the case with owner-occupied real estate loans. Also, the nonowner-occupied commercial real estate and multi-family residential business is cyclical and subject to downturns, over-building and local economic conditions. See discussion regarding the Bank s construction lending activities below.

Commercial and Industrial Loans The Bank originates non-real estate commercial loans that, in most instances, are secured by equipment, accounts receivable or inventory, as well as the personal guarantees of the principal owners of the borrower. Unlike many community banks, the Bank is able to offer asset-based commercial loan facilities that monitor advances against receivables and inventories on a formula basis. A number of commercial and industrial loans are granted in conjunction with the U.S. Small Business Administration s (SBA) loan guaranty programs and include some form of SBA credit enhancement. The Bank utilizes credit scoring in evaluating business loans of up to $750,000. Commercial lending activities are supported by noncredit products and services, such as letters of credit and cash management services, which are responsive to the needs of the Bank s commercial customers.

At December 31, 2009, commercial and industrial loans totaled $178.8 million, or 16.1% of the total loan and lease portfolio. Macrolease-generated equipment loans accounted for $43.1 million of the commercial and industrial portfolio. Generally, commercial and industrial loans have relatively shorter maturities than residential and commercial real estate loans, or are at adjustable rates without interest rate caps. Unlike residential and commercial real estate loans, which generally are based on the borrower s ability to make repayment from employment and rental income and which are secured by real property whose value tends to be relatively easily ascertainable, commercial and industrial loans are typically made on the basis of the borrower s ability to make repayment from the cash flow of the business and are generally secured by business assets, such as accounts receivable, equipment and inventory. As a result, the availability of funds for the repayment of commercial and industrial loans may be significantly dependent on the success of the business itself. Further, the collateral securing the loans may be difficult to value, may fluctuate in value based on the success of the business and may deteriorate over time.

Leases At December 31, 2009, leases comprised 6.1% of the total loan and lease portfolio. In May 2005, the Bank, through its Macrolease subsidiary, purchased substantially all of the operating assets of Macrolease International Corporation, a privately held national equipment financing company based on Long Island in Plainview, New York. With the Macrolease platform, the Bank originates equipment leases for its own portfolio, as well as originating leases for third parties as a source of noninterest income. From time to time, Macrolease purchases leases from third parties. Macrolease-generated leases were $54.5 million at December 31, 2009. Leases sold during 2009 totaled $11.1 million, which generated $326,000 of noninterest income.

In addition to the Macrolease platform, the Bank purchases equipment leases from originators outside of the Bank. The U.S. Government and its agencies are the principal lessees on the purchased leases. These government leases generally have maturities of five years or less and are not made dependent on residual collateral values. At December 31, 2009, the commercial loan and lease portfolio included $12.9 million of purchased government leases.

Small Business Loans The Bank utilizes the term small business loans to describe business lending relationships of approximately $500,000 or less which it originates through business development officers and its branch network. These loans are generally secured by the assets of the business, as well as the personal guarantees of the business principal owners. A number of these loans are granted in conjunction with the SBA s Low-Doc and Express programs and include some form of SBA credit enhancement. At December 31, 2009, small business loans totaled $56.1 million, or 5.1% of the total loan and lease portfolio. Generally, small business loans are granted at higher rates than commercial and industrial loans. These loans have relatively short-term maturities or are at adjustable rates without interest rate caps.

The Bank s underwriting practices for small business loans are designed to provide quick turn-around and minimize the fees and expenses to the customer. Accordingly, the Bank utilizes a credit scoring process to assist in evaluating potential borrowers. The Bank distinguishes itself from larger financial institutions by providing personalized service through a branch manager or business development officer assigned to the customer relationships. Lending to small businesses may involve additional risks as a result of their more limited financial and personnel resources.

Construction Loans The Bank originates residential construction loans to builders to construct one- to four-family residential units for resale. The Bank also makes construction loans for the purpose of constructing multi-family or commercial properties. At December 31, 2009, outstanding construction loans totaled $23.4 million, or 2.1% of the total loan and lease portfolio. During the construction period, these loans are generally on an interest-only basis.

The Bank s underwriting practices for construction loans are similar to those for commercial real estate loans, but they also are intended to assure completion of the project and take into account the feasibility of the project, among other things. As a matter of practice, the Bank generally lends an amount sufficient to pay a percentage of the property s acquisition costs and a majority of the construction costs but requires that the borrower have equity in the project. The Bank requires property appraisals and generally the personal guarantee of the borrower, as is the case with commercial real estate loans.

The risks associated with construction lending are greater than those with commercial real estate lending and multi-family lending on existing properties for a variety of reasons. The Bank seeks to minimize these risks by, among other things, often using the inspection services of a consulting engineer for commercial construction loans, advancing money during stages of completion and generally lending for construction of properties within its market area to

borrowers who are experienced in the type of construction for which the loan is made, as well as by adhering to the lending standards described above. The Bank generally requires from the borrower evidence of either pre-sale or pre-lease commitments on certain percentages of the construction project for which the loan is made.

Residential Mortgage Loans The Bank s one- to four-family residential mortgage loan portfolio consists primarily of whole loans purchased from other financial institutions. In past years, the Bank purchased fixed- and adjustable-rate (ARM) mortgage whole loans from other financial institutions both in New England and elsewhere in the country. The Bank performed due diligence procedures when purchasing these mortgages considering the loan characteristics such as debt to income ratio, loan to value ratio, credit score, property type and the level of credit enhancement. Although the Bank has not purchased any mortgages since 2007, the Bank anticipates continuing to purchase residential mortgage loans to the extent its commercial and consumer loan originations are not sufficient to fully utilize available cash flows. With the exception of approximately $29.0 million of purchased mortgages, servicing rights related to the whole loan mortgage portfolio are retained by the mortgage servicing companies. The Bank pays a servicing fee ranging from .25% to .375% to the mortgage servicing companies for administration of the loan portfolios. As of December 31, 2009, approximately 34% of the residential mortgage loan portfolio consisted of loans secured by real estate outside of New England.

Additionally, largely as an accommodation to the Bank s customers, fixed- and variable-rate mortgages are offered throughout the Bank s branch network. The majority of these mortgages are transferred to the Bank s correspondent third parties under precommitments to fund these transactions. However, the Bank does retain a portion of these residential mortgages for its own portfolio. In 2009, fees from these loans originated for third parties decreased to $83,000 from $100,000 in the prior year. Overall, the Bank anticipates that its residential mortgage loan portfolio will decline long-term as it continues to focus its resources on commercial and consumer lending.

At December 31, 2009, one- to four-family residential mortgage loans totaled $173.3 million, or 15.6% of the total loan and lease portfolio. The fixed rate portion of this portfolio totaled $56.7 million and had original maturities of 15 to 30 years. The adjustable rate portion of this portfolio totaled $115.9 and generally had original maturities of 30 years. Interest rates on adjustable rate loans are set for an initial period of one, three, five, seven or ten years with annual adjustments for the remainder of the loan. These loans have periodic rate adjustment caps of primarily 2% and lifetime rate adjustment caps of either 5% or 6%. There are no prepayment penalties for the one- to four-family residential mortgage loans.

Although adjustable rate mortgage loans allow the Bank to increase the sensitivity of its assets to changes in market interest rates, the terms of such loans include limitations on upward and downward rate adjustments. These limitations increase the likelihood of prepayments due to refinancings during periods of falling interest rates, particularly if rate adjustment caps keep the loan rate above market rates. Additionally, these limitations could keep the market value of the portfolio below market during periods of rising interest rates, particularly if rate adjustment caps keep the loan rate below market rates.

Consumer and Other Loans The Bank originates a variety of term loans and lines of credit for consumers. At December 31, 2009, the consumer loan portfolio totaled $206.2 million, or 18.5% of the total loan and lease portfolio. Over the past 5 years, consumer loans have increased by $38.8 million, or 23.2%. Compared to the prior year-end, consumer loans have decreased by $499,000, or 0.2%. The slight decrease in consumer and other loans from 2008 to 2009 reflects the runoff of existing consumer loans exceeding new originations.

Home equity term loans and home equity lines of credit comprised 98.8% of the consumer loan portfolio at December 31, 2009. These loans and lines of credit are generally offered for up to 80% of the appraised value of the borrower s home, less the amount of the remaining balance of the borrower s first mortgage. The Bank also offers direct automobile loans, savings secured loans and personal loans.

Asset Quality

The continued weak economy resulted in increased nonperforming assets and net charge-offs in 2009. At December 31, 2009, the Company had nonperforming assets of $20.0 million, or 1.26% of total assets, compared to $15.2 million, or 1.00% of total assets, at December 31, 2008. The Bank made additions to the allowance for loan and lease losses of $9.9 million and $4.5 million during 2009 and 2008 and experienced net charge-offs of $8.0 million and $2.5 million, respectively. At December 31, 2009, the allowance for loan and leases losses was $16.5 million and represented 1.49% of total loans and leases outstanding. This compares to an allowance for loan and lease losses of $14.7 million, representing 1.36% of total loans and leases outstanding at December 31, 2008. If current economic conditions continue or worsen, management believes that the level of nonperforming assets will increase, as will its

level of charged-off loans and leases.

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Investment Activities

Investments, an important component of the Company s diversified asset structure, are a source of earnings in the form of interest and dividends, and provide a source of liquidity to meet lending demands and fluctuations in deposit flows. Overall, the portfolio, comprised primarily of overnight investments, government sponsored enterprise (GSE) obligations, U.S Treasury obligations, mortgage-backed securities (MBSs), collateralized mortgage obligations (CMOs) and Federal Home Loan Bank of Boston (FHLB) stock, represents $400.1 million, or 25.2% of total assets, as of December 31, 2009. The majority of these securities are rated investment grade by at least one major rating agency. Loans and leases generally provide a better return than investments, and accordingly, the Company seeks to emphasize their generation rather than increasing its investment portfolio. The investments are managed by the Bank s Chief Financial Officer and Treasurer, subject to the supervision and review of the Asset/Liability Committee and are made in compliance with the Investment Policy approved by the Bank s Board of Directors.

Overall, in 2009, investments produced total interest and dividend income of $15.5 million, or 20.6%, of total interest and dividend income compared to $17.3 million, or 21.5% of total interest and dividend income, during 2008.

Deposits and Service Charges on Deposit Accounts

Deposits are the principal source of funds for use in lending and for other general business purposes. The Bank attracts deposits from businesses, non-profit entities, governmental entities and the general public by offering a variety of deposit products ranging in maturity from demand-type accounts to certificates of deposit (CDs). The Bank relies mainly on quality customer service and diversified products, as well as competitive pricing policies and advertising, to attract and retain deposits. The Bank emphasizes retail deposits obtained locally.

The Bank seeks to develop relationships with its customers in order to become their primary bank. In order to achieve this, the Bank has stressed growing its core deposit account base. Core deposits increased $92.4 million, or 14.9%, compared to the prior year. Within core deposits, demand deposit accounts increased to $204.3 million at December 31, 2009 from $176.5 million at December 31, 2008. Within total deposit growth, the balance sheet mix shifted from certificate of deposits to core deposit accounts. Savings balances declined to $367.2 million at December 31, 2009, a decrease of $13.9 million, or 3.6%, while certificate of deposit accounts decreased $36.3 million, or 8.6%, to $387.1 million at December 31, 2009. Core deposits as a percentage of total deposits increased to 64.8% at December 31, 2009 from 59.4% at December 31, 2008. Overall, total deposits increased $56.1 million, or 5.4%, at December 31, 2009 as compared to the prior year.

As a by-product of the Bank s emphasis on checking account growth, as well as deposit fee enhancement programs, service charges on deposit accounts, which include nonsufficient funds (NSF) fees, have grown over the years and represent the largest source of noninterest income for the Company. Service charges on deposit accounts decreased by $334,000, or 5.8%, from $5.7 million for 2008, to $5.4 million for 2009. Management believes the decline reflects a national trend driven by consumers aversion to unnecessary spending. If this trend continues or worsens, noninterest income may remain at or further decline from levels previously experienced. Additionally, in 2009, the FRB finalized changes to its consumer electronic funds transfer regulation (Regulation E). The changes limit the ability of financial institutions to charge NSF fees in certain circumstances. These changes to Regulation E will be effective July 1, 2010 and will require financial institutions to obtain consumer consent, or opt-in , before charging a consumer for paying overdrafts on automated teller machine and one-time debit card transactions. Management believes these changes will have a negative impact on noninterest income. There is also legislation pending in the U.S. Senate to further restrict NSF fees by limiting the number of overdrafts for which a financial institution may charge a consumer to one per month with an annual limit of six overdraft fees. If enacted, these proposed changes are likely to have a negative effect on the Bank s noninterest income.

The Bank generally charges early withdrawal penalties on its CDs in an amount equal to three months interest on accounts with original maturities of one year or less and six months interest on accounts with original maturities longer than one year. Interest credited to an account during any term may be withdrawn without penalty at any time during the term. Upon renewal of a CD, only interest credited during the renewal term may be withdrawn without penalty during the renewal term. The Bank s withdrawal penalties are intended to offset the potentially adverse effects of the withdrawal of funds during periods of rising interest rates.

As a general policy, the Bank reviews the deposit accounts it offers to determine whether the accounts continue to meet customers needs and the Bank s asset/liability management goals. This review is the responsibility of the Pricing Committee, which meets weekly to determine, implement and monitor pricing policies and practices consistent with the Bank s Asset and Liability Committee s strategy, as well as overall earnings and growth goals. The Pricing Committee analyzes the cost of funds and also reviews the pricing of deposit related fees and charges.

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Borrowings and Liquidity

The Bank derives cash flows from several sources, including loan and lease repayments, deposit inflows and outflows, sales of available for sale securities and FHLB and other borrowings. Loan and lease repayments and deposit inflows and outflows are significantly influenced by prevailing interest rates, competition and general economic conditions. To broaden its liquidity sources, the Bank uses such resources as brokered deposits, repurchase agreements and lines at the FRB.

The Bank utilizes borrowings on both a short- and long-term basis to compensate for reductions in normal sources of funds on a daily basis and as opportunities present themselves. The Bank will utilize borrowings and invest excess cash as part of its overall strategy to manage interest rate risk. At December 31, 2009, total borrowings were $350.8 million compared to $320.0 million at December 31, 2008.

The Bank has taken notice of the concerns that have been expressed about the FHLB and its ability to continue to repurchase member stock and discontinued dividends on its stock. As a member of the FHLB, the Bank is required to purchase FHLB stock in association with the Bank s outstanding advances. This stock is classified as a restricted investment and carried at cost. The FHLB is currently operating with retained earnings below its targeted level and has suspended its quarterly dividend and excess stock repurchases. The Bank will continue to monitor the credit quality of its funding sources, including the FHLB, and the related impact on its FHLB stock.

Nondeposit Investment Products and Services

Since January 2001, the Bank has managed a nondeposit investment program through which it makes available to its customers a variety of mutual funds, fixed- and variable-annuities, stocks, bonds and other fee-based products. These investment products are primarily offered through an arrangement with Commonwealth Equity Services, Inc., of Waltham, Massachusetts (Commonwealth). Commissions on nondeposit investment products for the years ending December 31, 2009 and 2008 were $776,000 and $745,000, respectively.

Employees

At December 31, 2009, the Company had 240 full-time and 26 part-time employees. The Company s employees are not represented by any collective bargaining unit, and the Company believes its employee relations are good. The Company maintains a benefit program that includes health and dental insurance, life and long-term disability insurance and a 401(k) plan.

Supervision and Regulation

Overview The Company and the Bank are subject to extensive governmental regulation and supervision. Federal and state laws and regulations govern numerous matters affecting the Bank and/or the Company, including changes in the ownership or control, maintenance of adequate capital, financial condition, permissible types, amounts and terms of extensions of credit and investments, permissible non-banking activities, the level of reserves against deposits and restrictions on dividend payments. These regulations are intended primarily for the protection of depositors and customers, rather than for the benefit of shareholders. Compliance with such regulation involves significant costs to the Company and the Bank and may restrict their activities. In addition, the passage of new or amended federal and state legislation could result in additional regulation of, and restrictions on, the operations of the Company and/or the Bank. The Company cannot predict whether any legislation currently under consideration will be adopted or how such legislation or any other legislation that might be enacted in the future would affect the business of either the Company or the Bank. The following descriptions of applicable statutes and regulations are not intended to be complete descriptions of these provisions or their effects on the Company and the Bank, but are brief summaries which are qualified in their entirety by reference to such statutes and regulations.

The Company and the Bank are subject to extensive periodic reporting requirements concerning financial and other information. In addition, the Bank and the Company must file such additional reports as the regulatory and supervisory authorities may require. The Company also is subject to the reporting and other dictates of the Securities Exchange Act of 1934, as amended (Exchange Act), and the Sarbanes-Oxley Act of 2002. Since 2002, changes to SEC rules have accelerated the reporting of numerous internal events and increased the Company s filing obligations and related costs.

The Company is a bank holding company registered under the Bank Holding Company Act of 1956, as amended (BHC Act). As a bank holding company, the Company is regulated by the FRB, and also is subject to certain laws of

the State of Rhode Island.

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The Bank is a Rhode Island chartered non-member bank of the Federal Reserve System. The Bank s deposits are insured by the Deposit Insurance Fund (DIF) of the FDIC. Accordingly, the Bank is subject to the supervision and regulation of the FDIC and the Rhode Island Department of Business Regulation (Department of Business Regulation).

Rhode Island Regulation

As a state chartered financial institution, the Bank is subject to the continued regulation and supervision and periodic examination by the Department of Business Regulation. Rhode Island law also imposes reporting requirements on the Bank. Rhode Island statutes and regulations govern among other things, investment powers, deposit activity, trust powers and borrowings. The approval of the Department of Business Regulation is required to establish, close or relocate a branch, merge with other banks, amend the Bank s Charter or By-laws and undertake certain other enumerated activities.

If it appears to the Department of Business Regulation that a Rhode Island bank has violated its charter, or any law or regulation, or is conducting its business in an unauthorized or unsafe manner, or that the bank has been notified by its federal insurer of such insurer s intent to terminate deposit insurance, the Director of the Department of Business Regulation (Director) may, under certain circumstances, restrict the withdrawal of deposits, order any person to cease violating any Rhode Island statutes or rules and regulations or cease engaging in any unsafe, unsound or deceptive banking practice, order that capital be restored, or suspend or remove directors, committee members, officers or employees who have violated the Rhode Island banking statutes, or a rule or regulation or order thereunder, or who are reckless or incompetent in the conduct of the bank s business.

Rhode Island law also requires any person or persons desiring to acquire control, as defined in the BHC Act, of any Rhode Island financial institution to file an extensive application with the Director. The application requires detailed information concerning the bank, the transaction and the principals involved. The Director may disapprove the acquisition if the proposed transaction would result in a monopoly, the financial stability of the institution would be jeopardized, the proposed management lacks competence, or the acquisition would not promote public convenience and advantage. The Company is also subject to the Rhode Island Business Combination Act.

In addition, whenever the Department of Business Regulation considers it advisable, the Department may conduct an examination of a Rhode Island bank holding company, such as the Company. Every Rhode Island bank holding company also must file an annual financial report with the Department of Business Regulation.

Federal Supervision: FDIC

Overview The FDIC issues rules and regulations, conducts periodic inspections, requires the filing of certain reports and generally supervises the operations of its insured state chartered banks that, like the Bank, are not members of the Federal Reserve System. The FDIC s powers have been enhanced in the past two decades by federal legislation. With the passage of the Financial Institutions Reform, Recovery and Enforcement Act of 1989, the Crime Control Act of 1990, and the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), federal bank regulatory agencies, including the FDIC, were granted substantial additional enforcement powers to restrict the activities of financial institutions and to impose or seek the imposition of increased civil and/or criminal penalties upon financial institutions and the individuals who manage or control such institutions.

The Bank is subject to the FDIC regulatory capital requirements described below under Regulatory Capital Requirements. An FDIC-insured bank also must conform to certain standards, limitations, and collateral requirements with respect to certain transactions with affiliates such as the Company. Further, an FDIC-insured bank is subject to laws and regulations that limit the amount of, and establish required approval procedures, reporting requirements and credit standards with respect to, loans and other extensions of credit to officers, directors and principal shareholders of the Company, the Bank, and any subsidiary of the Bank, and to their related interests. FDIC approval also is required prior to the Bank s redemption of any stock. The prior approval of the FDIC or, in some circumstances, another regulatory agency, is required for mergers and consolidations. In addition, notice to the FDIC is required prior to the closing of any branch office, and the approval of the FDIC is required in order to establish or relocate a branch facility.

Proceedings may be instituted against any FDIC-insured bank, or any officer or director or employee of such bank and any other institution affiliated parties who engage in unsafe and unsound practices, breaches of any fiduciary duty, or

violations of applicable laws, regulations, regulatory orders and agreements. The FDIC has the authority to terminate insurance of accounts, to issue orders to cease and desist, to remove officers, directors and other institution affiliated parties, and to impose substantial civil money penalties.

Deposit Insurance The Bank s deposits are insured by the DIF of the FDIC to the legal maximum for each separately insured depositor. The Federal Deposit Insurance Act, as amended (FDI Act), provides that the FDIC shall set deposit insurance assessment rates on a semiannual basis and requires the FDIC to increase deposit insurance assessments whenever the ratio of DIF reserves to insured deposits in the DIF is less than 1.25%.

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The FDIC has established a risk-based bank assessment system, the rates of which are determined on the basis of a particular institution s supervisory rating and capital level. Under the Federal Deposit Insurance Reform Act of 2005, which became law in 2006, the Bank received a one-time assessment credit of $585,000 that could be applied against premiums, subject to certain limitations. The Bank paid a minimum assessment of $2,000 in 2007, largely through the utilization of this one-time credit. In 2008, the Bank fully utilized the remainder of this credit. On May 22, 2009, the FDIC imposed a 5 basis point special assessment on the assets less Tier 1 Capital as of June 30, 2009 of all FDIC-insured institutions. The FDIC is authorized to levy an additional 5 basis points in special assessments. In addition to the special assessment, FDIC regular assessments increased for 2009. During 2008, financial institutions were assessed rates ranging from 5 basis points per $100 of deposits for institutions in Risk Category I to 43 basis points for institutions assigned to Risk Category IV. In 2009, rates ranged from 12 to 50 basis points per $100 of deposits.

In the fourth quarter of 2009, the FDIC voted to require insured institutions to prepay thirteen quarters of estimated insurance assessments. The estimated quarterly risk-based assessments for the fourth quarter of 2009 and for all of 2010, 2011, and 2012 were paid on December 30, 2009. Unlike the special assessment, the pre-payment allows the FDIC to strengthen the cash position of the DIF immediately without immediately impacting bank earnings.

The Emergency Economic Stabilization Act became law on October 3, 2008 and provides for a temporary increase in the basic limit on federal deposit insurance coverage from $100,000 to $250,000 per depositor. The basic deposit insurance limit will return to $100,000 on December 31, 2013. In addition, on October 14, 2008, the FDIC instituted a Temporary Liquidity Guarantee Program that provided for temporary unlimited FDIC coverage of non-interest-bearing deposit transaction accounts, low interest NOW accounts (NOW accounts that cannot earn more than 0.50% interest) and IOLTA accounts (transaction accounts). Institutions were automatically covered, without cost, under these programs for 30 days (later extended until December 5, 2008); however, after the specified deadline (December 5, 2008), institutions were required to opt-out of these programs if they did not wish to participate and incur fees thereunder. The Company elected to participate in the Transaction Account Guarantee Program (TAG program), which was extended to June 30, 2010. The initial TAG program expired on December 31, 2009 unless the institution elected to opt out of the extended TAG program. Under the TAG program in effect through December 31, 2009, an institution could provide full coverage on transaction accounts for an annual assessment of 10 basis points of any deposit amounts exceeding the $250,000 deposit insurance limit, in addition to the normal risk-based assessment. An institution that did not elect to opt out of the extended TAG program can provide full coverage on transaction accounts through June 30, 2010 for the annual assessment ranging from 15 basis points to 25 basis points, depending on the institution s Risk Category. The Company elected to participate in the extended TAG program. The expiration of the TAG program on June 30, 2010 could have an adverse impact on the deposit levels of customers that are sensitive to full FDIC insurance coverage.

The FDIC may terminate the deposit insurance of any insured depository institution if the FDIC determines that the institution had engaged in or is engaging in unsafe or unsound practices, is in an unsafe or unsound condition to continue operations, or has violated any applicable law, regulation, order or any condition imposed by the FDIC.

Safety and Soundness Standards The FDI Act also directs each federal banking agency to prescribe standards for safety and soundness for insured depository institutions and their holding companies relating to operations, management, asset quality, earnings and stock valuation.

Examination The FDIC requires that nearly all insured depository institutions have annual, on-site regulatory examinations and annual audits by an independent public accountant. Management must prepare an annual report, attested to by the independent public accountant, confirming management s responsibility in preparing financial statements, maintaining internal controls for financial reporting and complying with safety and soundness standards. The audit process must be overseen by an independent audit committee composed of outside directors, provided that the federal banking agencies may permit the committee to include inside directors if the bank is unable to find competent outside directors, so long as outside directors comprise a majority of the committee.

Federal Supervision: FRB

The BHC Act mandates that the prior approval of the FRB must be obtained in order for the Company to engage in certain activities such as acquiring or establishing additional banks or non-banking subsidiaries or merging with other

institutions and imposes capital adequacy requirements as described below under Regulatory Capital Requirements.

Regulatory Capital Requirements

FDIC Requirements FDIC-insured institutions must meet specified minimal capital requirements and are subject to varying regulatory restrictions based upon their capital levels. All banks are subject to restrictions on capital distributions (such as dividends, stock repurchases and redemptions) and payment of management fees if, after making such distributions or payment, the institution would be undercapitalized. FDIC-insured banks that have the highest regulatory rating and are not anticipating or experiencing significant growth are required to maintain a capital ratio calculated using Tier 1 capital (as defined below) to total assets (Tier 1 Leverage Ratio) of at least 3.0%. All other banks are required to maintain a minimum leverage capital ratio of 1.0% to 2.0% above 3.0%, with a minimum of 4.0%.

In addition, the FDIC has adopted capital guidelines based upon ratios of a bank s capital to total assets adjusted for risk, which require FDIC-insured banks to maintain capital-to-risk weighted asset ratios based on Tier 1 capital (Tier 1 Risk-Based Capital Ratio) of at least 4.0% and on total capital (Total Risk-Based Capital Ratio) of at least 8.0%. The guidelines provide a general framework for assigning assets and off-balance sheet items (such as standby letters of credit) to broad risk categories and provide procedures for the calculation of the Risk-Based Capital Ratio. Tier 1 (sometimes referred to as core) capital consists of common shareholders equity, qualifying, non-cumulative perpetual preferred stock, and minority interests in the equity accounts of consolidated subsidiaries. Supplementary or Tier 2 capital includes perpetual debt, mandatory convertible debt securities, a limited amount of subordinated debt, other preferred stock, and a limited amount of loan loss reserves. Certain intangible assets are deducted in computing the Capital Ratios.

Prompt Corrective Action Provisions In order to resolve the problems of undercapitalized institutions, FDICIA established a system known as prompt corrective action. Under prompt corrective action provisions and implementing regulations, every institution is classified into one of five categories reflecting the institution s capitalization. These categories are the following: well-capitalized, adequately-capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized. For an institution to be well-capitalized, it must have a Total Risk-Based Capital Ratio of at least 10%, a Tier 1 Risk-Based Capital Ratio of at least 6% and a Tier 1 Leverage Ratio of at least 5% and not be subject to any specific capital order or directive. In contrast, an institution will be deemed to be significantly undercapitalized if it has a Total Risk-Based Capital Ratio that is less than 6%, or a Tier 1 Risk-Based Capital Ratio that is less than 3%, or a leverage ratio that is less than 3%, and will be deemed to be critically undercapitalized if the bank has a ratio of tangible equity to total assets that is equal to or less than 2%.

As of December 31, 2009, the Bank s Tier 1 Leverage Ratio was 7.54%, its Tier 1 Risk-Based Capital Ratio was 10.55% and its Total Risk-Based Capital Ratio was 11.81%. Based upon the above ratios, the Bank is considered well-capitalized for regulatory capital purposes.

The activities in which a depository institution may engage and the remedies available to federal regulators vary depending upon the category described above into which an institution s level of capital falls. At each successive downward capital level, institutions are subject to more restrictions on their activities. For example, only well-capitalized institutions may accept brokered deposits without prior regulatory approval (brokered deposits are defined to include deposits with an interest rate which is 75 basis points (bps) above prevailing rates paid on similar deposits in an institution s normal market area).

The FDIC has broad powers to take prompt corrective action to resolve problems of insured depository institutions, depending upon a particular institution s level of capital. For example, a bank which does not meet applicable minimum capital requirements or is deemed to be in a troubled condition may be subject to additional restrictions, including a requirement of written notice to federal regulatory authorities prior to certain proposed changes in senior management or directors of the institution. Undercapitalized, significantly undercapitalized and critically undercapitalized institutions also are subject to a number of other requirements and restrictions.

FRB Requirements A bank holding company is required by the FRB to adhere to certain capital adequacy standards. It is the position of the FRB that a bank holding company, such as the Company, should be a source of financial strength to its subsidiary banks such as the Bank. In general, the FRB has adopted substantially identical capital adequacy guidelines as the FDIC. Such standards are applicable to bank holding companies and their bank subsidiaries on a consolidated basis for holding companies, like the Company, with consolidated assets in excess of

$150 million. If a bank holding company s capital levels fall below the minimum requirements established by the capital adequacy guidelines, the holding company will be expected to develop and implement a plan, acceptable to the FRB, to achieve adequate levels of capital within a reasonable time. Until such capital levels are achieved, the holding company may be denied approval by the FRB for certain activities such as those described in the preceding paragraph. As of December 31, 2009, on a consolidated basis, the Company s Tier 1 Leverage Ratio was 7.65%, its Tier 1 Risk-Based Capital Ratio was 10.71% and its Total Risk-Based Capital Ratio was 11.97%. Based upon the above ratios, the Company is considered well-capitalized for regulatory capital purposes.

Basel Accord U.S. bank regulatory authorities and international bank supervisory organizations, principally the Basel Committee on Banking Supervision (Basel Committee), continue to consider and to make changes to the risk-based capital adequacy framework, which could affect the appropriate capital guidelines to which the Company and the Bank are subject.

In 2005, the federal banking agencies issued an advance notice of proposed rulemaking concerning potential changes in the risk-based capital rules (Basel 1-A) that are designed to apply to and potentially reduce the risk capital requirements of bank holding companies, such as the Company, that are not among the core 20 or so largest U.S. bank holding companies (Core Banks). In December 2006, the FDIC issued a revised Interagency Notice of Proposed Rulemaking concerning Basel 1-A, which would allow banks and bank holding companies that are not among the Core Banks to either adopt Basel 1-A or remain subject to the existing risk-based capital rules. In July 2007, an interagency press release stated that the federal banking agencies have agreed to issue a proposed rule that would provide non-Core Banks with the option to adopt an approach consistent with the standardized approach of Basel II. This proposal would replace Basel 1-A. In December 2007, the federal banking agencies issued the final regulation that will implement Basel II for the Core Banks, permitting only the advanced approach. The final rule implementing Basel II reiterated that non-Core Banks would have the option to take the standardized approach. The rule also allows a banking organization s primary Federal supervisor to determine whether the application of the rule would not be appropriate in light of the bank s asset size, level of complexity, risk profile or scope of operations. The Bank is currently not required to comply with Basel II.

In July 2008, the federal banking agencies issued a proposed rule that would provide banking organizations that do not use the advanced approaches with the option to implement a new risk-based capital framework. This framework would adopt the standardized approach of Basel II for credit risk, the basic indicator approach of Basel II for operational risk and related disclosure requirements. While this proposed rule generally parallels the relevant approaches under Basel II, it diverges where United States markets have unique characteristics and risk profiles, most notably with respect to risk weighting residential mortgage exposures. Comments on the proposed rule were due to the agencies by October 27, 2008, but a definitive final rule had not been issued as of December 31, 2009. The proposed rule, if adopted, will replace the agencies earlier proposed amendments to existing risk-based capital guidelines to make them more risk sensitive (formerly referred to as the Basel I-A approach).

In December 2009, the Basel Committee on Banking Supervision released for comment a proposal to strengthen global capital regulations. The key elements of the proposal include raising the quality, consistency and transparency of the capital base, strengthening the risk coverage of the capital framework, introducing a leverage ratio that is different from the U.S. leverage ratio measures and promoting the build-up of capital buffers. The U.S. banking agencies are expected to issue a similar version of the proposal later this year. Although any U.S. proposal would apply to banking organizations subject to the Basel II regime to which the Company is not currently subject, the proposal might also impact the Company and other banking organizations. Additional proposals addressing these issues are expected in 2010.

Restrictions on Transactions with Affiliates and Insiders

The Bank is subject to certain federal statutes limiting transactions with non-banking affiliates and insiders. Section 23A of the Federal Reserve Act limits loans or other extensions of credit to asset purchases with, and investments in, affiliates of the Bank, such as the Company, to ten percent (10%) of the Bank s capital and surplus. Further, such loans and extensions of credit, as well as certain other transactions, are required to be secured in specified amounts. Section 23B of the Federal Reserve Act, among other things, requires that certain transactions between the Bank and its affiliates must be on terms substantially the same, or at least as favorable to the Bank, as those prevailing at the time for comparable transactions with or involving other nonaffiliated persons. In the absence of comparable transactions, any transaction between the Bank and its affiliates must be on terms and under circumstances, including credit standards, that in good faith would be offered to or would apply to nonaffiliated persons.

The restrictions on loans to officers, directors, principal shareholders and their related interests (collectively referred to herein as insiders) contained in the Federal Reserve Act and Regulation O apply to all institutions and their subsidiaries. These restrictions include limits on loans to one borrower and conditions that must be met before such

loans can be made. Loans made to insiders and their related interests cannot exceed the institution s total unimpaired capital and surplus. Insiders are subject to enforcement actions for knowingly accepting loans in violation of applicable restrictions. All extensions of credit by the Bank to its insiders are in compliance with these restrictions and limitations.

Loans outstanding to executive officers and directors of the Bank, including their immediate families and affiliated companies (related parties), aggregated $8.4 million at December 31, 2009 and $9.8 million at December 31, 2008. Loans to related parties are made in the ordinary course of business under normal credit terms, including interest rates and collateral, prevailing at the time of origination for comparable transactions with other unaffiliated persons, and do not represent more than normal credit risk.

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Interstate Banking

The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 facilitated the interstate expansion and consolidation of banking organizations by permitting (i) bank holding companies such as the Company, that are adequately capitalized and managed, to acquire banks located in states outside their home states regardless of whether such acquisitions are authorized under the law of the host state, (ii) the interstate merger of banks after June 1, 1997, subject to the right of individual states to opt in early or opt out of this authority prior to such date, (iii) banks to establish new branches on an interstate basis provided that such action is specifically authorized by the law of the host state, (iv) foreign banks to establish, with approval of the appropriate regulators in the United States, branches outside their home states to the same extent that national or state banks located in such state would be authorized to do so and (v) banks to receive deposits, renew time deposits, close loans and receive payments on loans and other obligations as agent for any bank or thrift affiliate, whether the affiliate is located in the same or different state. Rhode Island adopted opt in legislation, which permits full interstate banking acquisition and branching.

Gramm-Leach-Bliley Act

In late 1999, Congress enacted the Gramm-Leach-Bliley Act (G-L-B Act), which repealed provisions of the 1933 Glass-Steagall Act that required separation of the commercial and investment banking industries. The G-L-B Act expands the range of non-banking activities that certain bank holding companies may engage in while preserving existing authority for bank holding companies to engage in activities that are closely related to banking. In order to engage in these new non-banking activities, a bank holding company must qualify and register with the FRB as a financial holding company by demonstrating that each of its banking subsidiaries is well-capitalized and well-managed and has a rating of Satisfactory or better under the Community Reinvestment Act of 1977.

Under the G-L-B Act and its implementing regulations, financial holding companies may engage in any activity that (i) is financial in nature or incidental to a financial activity under the G-L-B Act or (ii) is complementary to a financial activity and does not impose a substantial risk to the safety and soundness of depository institutions or the financial system generally. The G-L-B Act and its accompanying regulations specify certain activities that are financial in nature such as acting as principal, agent or broker for insurance; underwriting, dealing in or making a market in securities; and providing financial and investment advice. The new financial activities authorized by the G-L-B Act may also be engaged in by a financial subsidiary of a national or state bank, except for insurance or annuity underwriting, insurance company portfolio investments, real estate investments and development and merchant banking, which must be conducted in a financial holding company. The FRB and the Secretary of the Treasury have the authority to decide whether other activities are also financial in nature or incidental thereto, taking into account changes in technology, changes in the banking marketplace, competition for banking services and other pertinent factors. Although the Company may meet the qualifications to become a financial holding company, it has no current plans to elect such status.

The G-L-B Act also establishes a system of functional regulation, under which the federal banking agencies will regulate the banking activities of financial holding companies and banks financial subsidiaries, the SEC will regulate their securities activities and state insurance regulators will regulate their insurance activities. In addition, the G-L-B Act provides protection against the transfer and use by financial institutions of consumers nonpublic, personal information. The G-L-B Act contains a variety of additional provisions, which, among others, impose additional regulatory requirements on certain depository institutions and reduce certain other regulatory burdens, modify the laws governing the Community Reinvestment Act of 1977, and address a variety of other legal and regulatory issues affecting both day-to-day operations and long-term activities of financial institutions.

In granting other types of financial institutions more flexibility, the G-L-B Act has increased the number and type of institutions engaging in the same or similar activities as those of the Company and the Bank, thereby creating a more competitive atmosphere.

Other Aspects of Federal and State Laws

Community Reinvestment Act The Community Reinvestment Act of 1977 (CRA) and the regulations issued thereunder are intended to encourage banks to help meet the credit needs of their service area, including low and moderate income neighborhoods, consistent with the safe and sound operations of the banks. Under CRA, banks are rated on their performance in meeting these credit needs and the rating of a bank s performance is public. In connection

with the filing of an application to conduct certain transactions, the CRA performance record of the banks involved are reviewed. Under the Bank s last CRA examination, the Bank received a Satisfactory rating.

USA PATRIOT Act The USA PATRIOT Act of 2001 (the Patriot Act), designed to deny terrorists and others the ability to obtain anonymous access to the United States financial system, has significant implications for depository institutions, brokers, dealers and other businesses involved in the transfer of money. The Patriot Act requires financial institutions to implement additional policies and procedures with respect to, or additional measures designed to address, the following matters, among others: money laundering; suspicious activities and currency transaction reporting; and currency crimes.

Sarbanes-Oxley Act of 2002 In July 2002, Congress enacted the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley) which imposed significant additional requirements and restrictions on publicly-held companies, such as the Company. These provisions include requirements governing the independence, composition and responsibilities of audit committees, financial disclosures and reporting and restrictions on personal loans to directors and officers. Sarbanes-Oxley, among other things, mandates chief executive and chief financial officer certifications of periodic financial reports, additional financial disclosures concerning off-balance sheet items, and speedier transaction reporting requirements for executive officers, directors and 10% shareholders. Rules promulgated by the SEC pursuant to Sarbanes-Oxley impose obligations and restrictions on auditors and audit committees intended to enhance their independence from management. In addition, penalties for non-compliance with the Exchange Act are heightened. The Company has not experienced any significant difficulties in complying with this legislation. However, the Company has incurred, and expects to continue to incur, costs in connection with its compliance with Section 404 of Sarbanes-Oxley which requires management to undertake an assessment of the adequacy and effectiveness of the Company s internal controls over financial reporting and requires the Company s auditors to attest to, and report on, the operating effectiveness of these controls.

Insurance Sales Rhode Island legislation enacted in 1996 permits financial institutions to participate in the sale of insurance products, subject to certain restrictions and license requirements. The regulatory approvals required from the Department of Business Regulation and the FDIC depend upon the form and structure used to engage in such activities.

Miscellaneous The Company and/or the Bank also are subject to federal and state statutory and regulatory provisions covering, among other things, reserve requirements, security procedures, currency and foreign transactions reporting, insider and affiliated party transactions, management interlocks, sales of non-deposit investment products, loan interest rate limitations, truth-in-lending, electronic funds transfers, funds availability, truth-in-savings, home mortgage disclosure and equal credit opportunity.

Recent Regulatory Developments

Financial Stability Plan On February 10, 2009, the Treasury announced the Financial Stability Plan (FS Plan), a comprehensive set of measures intended to shore up the U.S. financial system. The core elements of the plan include making bank capital injections, creating a public-private investment fund to buy troubled assets, establishing guidelines for loan modification programs and expanding the FRB lending program. The U.S. Treasury has indicated more details regarding the FS Plan are to be announced at a future date.

Temporary Debt Guaranty Program The FDIC s Temporary Liquidity Guarantee Program announce on October 14, 2008 also provided for FDIC guarantees of unsecured debt of depository institutions and certain holding companies. The Company elected to participate in the temporary debt guaranty program. Under the terms of this program, the Company was eligible to issue prior to June 30, 2009 up to $27.5 million of senior unsecured debt guaranteed by the FDIC until the earlier of the maturity of such debt or June 30, 2012. Such guaranteed debt would be subject to an annual assessment amount ranging from 50 to 100 basis points depending on its maturity date. The Company did not issue debt in 2009 and was not subject to an additional assessment under the temporary debt guarantee program.

American Recovery and Reinvestment Act of 2009 **-** On February 17, 2009, the American Recovery and Reinvestment Act of 2009 (ARRA) was enacted. ARRA is intended to provide a stimulus to the U.S. economy in light of the significant economic downturn. ARRA includes federal tax cuts, expansion of unemployment benefits and other social welfare provisions, and domestic spending in education, healthcare, and infrastructure, including the energy structure. ARRA also includes numerous non-economic recovery related items, including a limitation on executive compensation in federally aided financial institutions. Under ARRA, an institution will be subject to a number of restrictions and standards through-out the period in which any obligation arising from financial assistance provided

under TARP remains outstanding.

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Homeowner Affordability and Stability Plan On February 18, 2009, President Obama announced the Homeowner Affordability and Stability Plan (HASP). HASP is intended to support a recovery in the housing market and ensure that workers can continue to pay off their mortgages through the following elements:

- Provide access to low-cost refinancing for responsible homeowners suffering from falling home prices.
- A $75.0 billion homeowner stability initiative to prevent foreclosure and help responsible families stay in their homes.
- Support low mortgage rates by strengthening confidence in Fannie Mae and Freddie Mac.

Overdraft Protection On November 12, 2009, the FRB amended Regulation E, to limit the ability to assess overdraft fees for paying ATM and one-time debit card transactions that overdraw a consumer s account, unless the consumer opts into such payment of overdrafts. The new rule does not apply to overdraft services with respect to checks, ACH transactions, or recurring debit card transactions, or to the payment of overdrafts pursuant to a line of credit or a service that transfers funds from another account. We are required to provide to customers written notice describing our overdraft service, fees imposed, and other information, and to provide customers with a reasonable opportunity to opt in to the service. Before we may assess fees for paying discretionary overdrafts, a customer must affirmatively opt in, which could negatively impact our noninterest income.

Proposed Legislation and Regulatory Action

Financial regulatory reform continues to be a top priority for the Obama Administration. The U.S. House of Representatives (the House) passed the Wall Street Reform and Consumer Protection Act on Dec. 11, 2009. The U.S. Senate has not yet enacted legislation in this area. The Senate Banking Committee draft bill, Restoring American Financial Stability Act of 2009 is still in draft form and currently under discussion. Both legislative products focus on measures to improve financial stability, provide for more effective bank supervision, enhance the regulation of consumer financial products and services through the establishment of a Consumer Financial Protection Agency and allow for better coordination between regulatory agencies. The House s bill would establish a Systemic Dissolution Fund to help wind down financial institutions when necessary. The fund would be pre-funded by FDIC assessments on large financial companies with assets exceeding $50.0 billion, to pay for the resolution of a bank holding company, a systemically important financial company, an insurance company or any other financial company. The Senate Banking Committee s draft proposal has a similar resolution mechanism and sets the threshold at $10 billion or more.

New regulations and statutes are regularly proposed that contain wide-ranging proposals for altering the structures, regulations and competitive relationships of the nation s financial institutions. The Company cannot predict whether or in what form any proposed regulation or statute will be adopted or the extent to which the business may be affected by any new regulation or statute. In the current environment, the nature and extent of future legislative and regulatory changes affecting financial institutions are very unpredictable at this time.

Effect of Governmental Policy

The Company s revenues consist of cash dividends paid to it by the Bank. Such payments are restricted pursuant to various state and federal regulatory limitations. Banking is a business that depends heavily on interest rate differentials. One of the most significant factors affecting the Bank s earnings is the difference between the interest rates paid by the Bank on its deposits and its other borrowings, on the one hand, and, on the other hand, the interest rates received by the Bank on loans extended to its customers and on securities held in the Bank s portfolio. The value and yields of its assets and the rates paid on its liabilities are sensitive to changes in prevailing market rates of interest. Thus, the earnings and growth of the Bank will be influenced by general economic conditions, the monetary and fiscal policies of the federal government, and policies of regulatory agencies, particularly the FRB, which implements national monetary policy. Management cannot predict the nature or impact of future changes in monetary and fiscal policies.

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ITEM 1A. RISK FACTORS

Overview

Investing in our common stock involves a degree of risk. The risks and uncertainties described below are not the only ones facing our Company. Additional risks and uncertainties may also impair our business operations. If any of the following risks actually occur, our business, financial condition or results of operations would likely suffer.

Risks Related to Our Business

Recent negative developments in the financial services industry and U.S. and global credit markets may adversely impact our operations and results.

During 2008 and the first half of 2009, capital and credit markets experienced unprecedented levels of volatility and disruption. These negative developments in the capital markets have resulted in uncertainty in the financial markets in general and a significant economic downturn in 2009 which has continued into 2010. Loan portfolio performances have deteriorated at most institutions, including the Bank, resulting from, among other factors, a weak economy and a decline in the value of the collateral supporting their loans. The competition for our deposits has increased significantly due to liquidity concerns at many of these same institutions. Stock prices of bank holding companies, like ours, have been negatively affected by the current condition of the financial markets, as has our ability, if needed, to raise capital or borrow in the debt markets compared to recent years. Additionally, there is a potential for new federal or state laws and regulations regarding lending and funding practices and liquidity standards, and financial institution regulatory agencies have been and are expected to continue to be aggressive in responding to concerns and trends identified in examinations, including the issuance of many formal enforcement actions. Negative developments in the financial services industry and the impact of new legislation in response to those developments have, and may continue to negatively impact our operations by restricting our business operations and imposing increased costs, and adversely impact our financial performance.

The continuation of adverse market conditions in the U.S. economy and the markets in which we operate could adversely impact us.

The continued deterioration of overall market conditions adversely affected our financial performance in 2009. A continued economic downturn or prolonged economic stagnation in the U.S. markets and our markets may have further negative impacts on our business. The failure of the U.S. y 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 SEC, 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 the Company relies 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 statements are qualified by reference to the following cautionary statements.

We are dependent on a few large customers, the loss of any of which could substantially harm our business and operating results.

Historically, a substantial percentage of our sales have been made to a small number of customers. During the years ended December 31, 2009, 2010 and 2011, sales to customers who account for 10% or more of our net sales totaled approximately 63.3%, 71.0% and 84.0% of our net sales, respectively. During these same years, sales to our largest 10 customers accounted for 86.2%, 88.4% and 93.0% of our net sales, respectively. We currently depend, and expect to continue to depend, on a relatively small number of customers for a significant percentage of our net revenue. If our customers, particularly our major customers, experience a decline in the demand for their products as a result of the prevailing economic environment or other factors, the electronic manufacturing services, or EMS, that we provide to these customers could be curtailed or possibly even terminated. The loss of any one of our major customers or a substantial reduction in orders from any of them could 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, we generate significant account receivables in connection with the EMS that we provide to our customers. If one or more of our customers became insolvent or otherwise were unable to pay for these services on a timely basis, or at all, our operating results and financial position could be adversely affected. Such adverse effects could include any one or more of the following: a further decline in revenue or net income, a charge for bad debts, a charge for inventory write-offs, a decrease in inventory turns, an increase in days in inventory and an increase in days in accounts receivable.

Consolidation in industries that utilize or manufacture electronics components may adversely affect our business.

Consolidation in industries that utilize electronic components may continue to increase as companies combine to achieve further economies of scale and other synergies. Further consolidation could result in an increase in excess manufacturing capacity as companies seek to divest manufacturing operations or eliminate duplicative product lines. Excess manufacturing capacity may decrease pricing and increase competitive pressures for our industry as a whole and for us in particular. Consolidation could also result in an increasing number of very large companies offering products in multiple industries. If one of our customers is acquired by another company that does not rely on us to provide services and has its own production facilities or relies on another provider of similar services, we may lose that customer s business. Such consolidation among our customers may further reduce the number of customers that generate a significant percentage of our net revenue and exposes us to increased risks relating to our reliance on a small number of customers. Any of the foregoing results of industry consolidation could adversely affect our business.

In addition, consolidation in our industry would result in larger and more geographically diverse competitors that have significantly larger combined resources, which may allow them to devote significantly greater resources to the expansion of the EMS that they offer and the marketing of their existing services to their larger installed customer bases or to new customers attracted to a larger global manufacturing organization.

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Continuing economic uncertainty may adversely affect our earnings, liquidity and financial position.

The business environment in the electronics industry depends significantly on worldwide economic conditions. In particular, there has been an erosion of global consumer confidence from concerns over declining asset values, price instability, geopolitical issues, the availability and cost of credit, rising unemployment, and the stability and solvency of financial institutions, financial markets, businesses, and sovereign nations. These concerns slowed global economic growth and resulted in recessions in many countries, including in the U.S., Europe and certain countries in Asia. The global economic downturn negatively impacted our operating results beginning in the second half of 2008 through the first quarter ended March 31, 2010.

Even though there were signs that an overall economic recovery was beginning in the second quarter of 2010 and throughout 2011, such recovery continues to be uncertain. Recessionary conditions may return. If any of these potential negative economic conditions occur, a number of negative effects on our business could result and adversely affect:

- the demand for our customers products;
- the amount, timing and stability of their orders;
- the financial strength of our customers and suppliers;
- our customers and suppliers ability or willingness to do business with us;
- our willingness to do business with our current customers and suppliers;
- our suppliers and customers ability to fulfill their obligations to us;
- our customers , our suppliers or our ability to obtain credit, secure funds or raise capital; and
- the prices at which we can sell our products and services.

Any of these effects could impact our ability to effectively manage inventory levels and collect receivables, increase our need for cash, or decrease our net revenue and profitability. As a result, continuing economic uncertainty may adversely affect our earnings, liquidity and financial position and no assurance can be given that we will not be impacted by changes in the economic environment or perceived changes in the economic environment.

Our quarterly and annual operating results are subject to significant fluctuations as a result of a wide variety of factors.

Substantially all of our sales are made on purchase order bases, and we are not always able to predict with certainty the timing or magnitude of these orders, especially during the current global economic downturn. We cannot guarantee that we will continue to receive orders from any of our customers. Our net sales will be harmed if we are unable to obtain a sufficient number of orders from, perform a sufficient number of EMS for, or ship a sufficient number of products to our customers in each quarter. In addition, our customers may cancel, change or delay product purchase orders with little or no advance notice to us. Also, we believe customers may be increasing the number of vendors upon which they rely for manufacturing. Our quarterly and annual operating results are affected by a wide variety of factors that could materially and adversely affect our business and operating results during any period. This could result from any one or a combination of factors, such as:

the timing, cancellation or deferral of orders;

adverse changes in global economic conditions, particularly those affecting the electronics industry;

the level of capacity utilization of our manufacturing facilities and associated fixed costs;

the composition of the costs of revenue between materials, labor and manufacturing overhead;

changes in demand for our products or services;

changes in demand in our customers end markets, which affect the type of product and related margins;

our customers announcement and introduction of new products or new generations of products;

the efficiencies we achieve in managing inventories and fixed assets;

the degree to which we are able to utilize our available manufacturing capacity;

long national seasonal breaks in the PRC, such as the Chinese New Year holidays in our first quarter and the National Day Golden week in our fourth quarter, during which our ability to manufacture products, obtain components and materials from suppliers and receive and process orders from customers are adversely affected;

fluctuations in the cost of materials and the availability of materials;

the life cycles of our customers products;

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- variability in our manufacturing yields;
- long lead times and advance financial commitments for our factories, equipment expenditures and components required to complete anticipated customer orders;
- our effectiveness in managing our manufacturing processes, including, interruptions or slowdowns in production and changes in cost and availability of components;
- changes in the specific products or quantities our customers order;
- extended payment terms demanded by our major customers which, for competitive reasons, we choose to accommodate and result in longer periods for us to receive payment and increase our accounts receivable;
- customer insolvencies resulting in bad debt or inventory exposures that are in excess of our reserves;
- charges to our operating results because of impairments to the values of long-lived assets or goodwill carried on our balance sheet; and
- price reductions caused by competitive pressure.

The volume and timing of orders received during a quarter have been, even in normal economic climates, difficult to forecast and fluctuate as a consequence of variation in demand for our customers products; our customers attempts to manage their inventory; electronic design changes; changes in our customers manufacturing strategies; and acquisitions of or consolidations among our customers. Customers generally order based on their forecasts. Further, we do not typically operate with any significant backlog in orders, and this makes it difficult for us to forecast our revenues, plan our production and allocate resources for future periods (including for our capital expenditures). If demand falls below such forecasts or if customers do not control inventories effectively, they may reduce, cancel or postpone shipments of orders.

Because of any of the above factors, our operating results in any period should not be considered indicative of results to be expected in any future period, and fluctuations in operating results may also result in fluctuations in the market price of our common shares. Our operating results in future periods may fall below the expectations of public market analysts and investors. This failure to meet expectations could cause the trading price of our common shares to decline.

We face increasing competition, which has had and may continue to have, an adverse effect on our gross margins.

Certain barriers to entry exist in the EMS industry such as technical expertise, substantial capital requirements, and establishing and maintaining valuable customer relationships and a large and loyal customer base. However, these barriers to entry are relatively low. We are aware that manufacturers in Hong Kong and China may be developing or have developed the required technical capability and customer base to compete with our existing business.

Competition in the EMS industry is intense, characterized by price erosion, rapid technological change and competition from major international companies. This intense competition has resulted in pricing pressures and a lower gross margin percentage in certain years. Our gross margin percentages during the years ended December 31, 2007, 2008, 2009, 2010 and 2011 are shown in the chart below.

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During 2011, our gross profit margin dropped from 9.6% to 4.7% as compared with 2010. In 2011, we were still burdened with launch costs for new projects in our facility in Wuxi which reduced our overall gross profit margin by 2.0%. Additional launch costs for new projects could impact our overall gross profit margin in the future. Wages and allowance increased by 48%, which reduced our overall gross profit margin by 1.6%. Additionally, in the future, we may not be able to improve on, or even maintain, our gross margin percentage at the 2011 level. If, as a result of competitive forces, we are compelled to lower our unit prices and are unable to otherwise offset the recent trend of decreases in our gross margin percentage, our financial position may be harmed and our stock price may fall.

We may not be able to compete successfully with our competitors, many of which have substantially greater resources than we do. We will face intense competition when we begin large-scale production of flexible printed circuit, or FPC, boards and FPC subassemblies.

The EMS we provide are available from many independent sources as well as from our current and potential customers with in-house manufacturing capabilities. The following table identifies those companies, which we believe are our principal competitors (listed alphabetically) by category of products or services we provide:

Product/Service	Competitor
EMS	Celestica, Inc. Flextronics International Ltd. Hon Hai Precision Industry Co., Ltd. Jabil Circuit, Inc. Sanmina-SCI Corporation
Image capturing devices and their modules	Altus Technology Inc. (controlled by Foxconn) Lite-on Technology Corporation Logitech International S.A. The Primax Group
Mobile phone accessories	Balda-Thong Fook Solutions Sdn., Bhd. Celestica, Inc. Elcoteq Network Corporation Flextronics International Ltd. Foster Corporation Foxlink Group Merry Electronics Co., Ltd. WKK International (Holdings) Ltd.
Liquid crystal display, or LCD panels	Tianma Microelectronics Co., Ltd. Truly International Holdings Ltd. Varitronix International Ltd. Yeebo (International) Holdings Ltd.
Telecommunication subassemblies and components	Flextronics International Ltd. LG. Philips LCD Co., Ltd. Samsung Electronics Varitronix International Ltd.
Consumer electronic products (calculators, personal organizers and linguistic products)	Computime Limited Inventec Co., Ltd. Kinpo Electronics, Inc. VTech Holdings Limited
FPC boards/FPC subassemblies	Ichia Technologies Inc. Nitto Denko (HK) Ltd. NOK Corporation Sumitomo Chemical Co., Ltd. Fujikura Ltd.

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Many of our competitors have greater financial, technical, marketing, manufacturing, regional shipping capabilities, logistics support and personnel resources than we do. Consolidation among our competitors could result in even larger competitors emerging. As a result, we may be unable to compete successfully with these organizations in the future.

In addition to intense competition from large FPC board manufacturers located in Taiwan, China, Korea, Singapore, North America, Japan and Europe, we also face such competition from large, established EMS providers that have acquired or, like we have, developed their own FPC manufacturing capabilities, and have extensive experience in electronics assembly. Furthermore, many companies in our target customer base are moving the design and manufacturing of their products to original engineering manufacturers, or OEMs, in Asia. OEMs could create pressure on us to provide discounts or lower prices to gain or maintain market share, which could adversely affect our margins and the profitability of our FPC business and our operating results as a whole. In addition, if we are unable to capture significant original design manufacturers (ODMs) as customers, we may be unable to sustain or grow our FPC business.

Cancellations or delays in orders could materially and adversely affect our gross margins and operating results.

Our sales to OEMs are primarily based on purchase orders that we receive from time to time rather than firm, long-term purchase commitments. Although it is our general practice to purchase raw materials only upon receiving a purchase order, for certain customers we will occasionally purchase raw materials based on such customers rolling forecasts. Further, during times of potential component shortages, we have purchased, and may continue to purchase, raw materials and component parts expecting that we will receive purchase orders for products that use these components. In the event actual purchase orders are delayed, are not received or are cancelled and we declined any other potential orders that may arise, we would experience increased inventory levels or possible write-offs of obsolete inventory, write-downs of raw materials inventory or the underutilization of our manufacturing capacity.

Our customers face numerous competitive challenges, such as rapid technological changes and short life cycles for their products, which may materially adversely affect both their business and ours.

Factors affecting the industries that utilize electronic components, and our customers specifically, could seriously harm our customers and, as a result, us. These factors include:

- The inability of our customers to adapt to rapidly changing technology and evolving industry standards, which may result in short product life cycles;
- The inability of our customers to develop and market their products, some of which are new and untested;
- The potential that our customers products may become obsolete or the failure of our customers products to gain widespread commercial acceptance;
- Recessionary periods in our customers markets;
- Increased competition among our customers and their respective competitors which may result in a loss of business, or a reduction in pricing power, for our customers; and
- New product offerings by our customers competitors may prove to be more successful than our customers product offerings.

If our customers are unsuccessful in addressing these competitive challenges, or any others that they may face, then their business may be materially adversely affected, and as a result, the demand for our services could decline.

Our business has been characterized by a rapidly changing mix of products and customers.

Since 2007, we have targeted markets that we believe offer significant growth opportunities and for which OEMs sell complex products that are subject to rapid technological change. We believe that markets involving complex, rapidly changing products offer us opportunities to produce products with higher margins because these products require higher value-added manufacturing services and may also include advanced components. We expect that our current mix of customers and products will continue to change rapidly, and we believe this to be relatively common in the EMS industry. If the products we manufacture for our customers become obsolete or less profitable and we are not able to diversify our product offerings or expand customer base in a timely manner, our business could be materially and adversely affected.

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There may not be a sufficient market for new products that our customers or we develop.

Our customers may not develop new products in a timely and cost-effective manner, or the market for products they choose to develop may not grow or continue in line with their expectations. This would reduce the overall businesses they outsource, which would seriously affect our business and operating results. Even if we develop capabilities to manufacture new products, there can be no guarantee that a market exists or will develop for such products or that such products will adequately respond to market trends. If we invest resources to develop capabilities to manufacture or expand capabilities for existing and new products, like our investments in our new factory in Wuxi, China and in the land in Guangming Hi-Tech Industrial Park in Shenzhen, China for which sales do not develop, our business and operating results could be seriously harmed. Even if the market for our services grows, it may not grow at an adequate pace.

We must spend substantial amounts to maintain and develop advanced manufacturing processes and engage additional engineering personnel in order to attract new customers and business.

We operate in a rapidly changing industry. Technological advances and the introduction of new products and new manufacturing and design techniques could materially and adversely affect our business unless we are able to adapt to those changing conditions. As a result, we are continually required to commit substantial funds for, and significant resources to, engaging additional engineering and other technical personnel and to purchase advanced design, production and test equipment. Our future operating results will depend to a significant extent on our ability to continue to provide new manufacturing solutions which, based on time to introduction, cost and performance with the manufacturing capabilities of OEMs and competitive third-party suppliers compare favorably to those offered by our competitors. Our success in attracting new customers and developing new business depends on various factors, including:

- the utilization of advances in technology;
- the development of new or improved manufacturing processes for our customers products;
- the delivery of efficient and cost-effective services; and
- the timely completion of manufacturing of new products.

Our business is capital intensive and the failure to generate sufficient cash could require that we curtail capital expenditures.

To remain competitive, we must continue to make investments in capital equipment, facilities and technological improvements. We plan to finance our expansion with capital we generate from operations. If we are unable to generate sufficient funds to conduct existing operations and fund our expansion, we may have to curtail our capital expenditures. Any curtailment of our capital expenditures could result in a reduction in net sales, the reduction or elimination of dividends to shareholders, the reduced quality of our products, increased manufacturing costs for our products, harm to our reputation and reduced manufacturing efficiencies.

Our inability to obtain local government approvals to release or obtain lands needed for our planned expansion projects could limit our future manufacturing capacity and adversely impact our growth and potentially our financial results when our existing capacity is reached.

Currently, we have two separate projects planned for expansion, including:

- the development of raw land in the Guangming Hi-Tech Industrial Park in Shenzhen, China that we acquired in 2007 into new manufacturing and support facilities to supplement our current manufacturing capabilities at our principal manufacturing facilities in Shenzhen, China; and

the acquisition and development of raw land adjacent to our recently operational manufacturing facility in Wuxi, China in order to construct buildings to support our operations in Wuxi, such as: dormitories, a canteen, a labor activity center, a research laboratory and testing and training centers.

All capital construction and expansion projects in China require a number of government approvals, which are subject to a variety of regulatory, economic and policy factors that are beyond our control. For example, although we fully paid the local government for the land use rights at our Guangming property in 2007, the government has delayed the release of this land to us and we have not been able to commence development of the property. In the case of our planned expansion in Wuxi, while the local Wuxi government has indicated to us that it strongly supports our expansion and development, it has been slow in providing the approvals and documentation necessary for us to consummate the acquisition of the land use rights and begin development.

We believe that the immediate expansion of our manufacturing facilities in Shenzhen is needed. We expect that our production capacity will be fully utilized by the end of 2012 at our principal manufacturing facilities in Shenzhen. Similarly, we expect that our existing Wuxi facilities will reach full capacity by 2013. In order to increase capacity and house additional workers at our Wuxi facilities, we believe we need to complete construction of the planned adjunct facilities by 2013.

When we receive government approval, construction at Guangming and Wuxi could be further delayed by construction delays, equipment delays or shortages, labor shortages or disputes or other unexpected events. If we reach our manufacturing capacity before we are able to complete development of our planned expansion projects we may not be able to accept new customers or serve our existing customers adequately and could potentially lose them, either of which could harm our growth, profitability and financial results.

We generally do not have written agreements with suppliers to obtain components and our margins and operating results could suffer from price increases of components.

For certain customers, we are responsible for purchasing components used in manufacturing their products. We do not have written agreements with some of our suppliers of components and, in many cases, we bear the risk of cost increases. We may be unable to procure the required materials at a price level necessary to generate anticipated margins from the orders of our customers. Accordingly, increases in component prices could materially and adversely affect our gross margins and operating results.

Our business and operating results would be materially and adversely affected if our component suppliers fail to meet our needs.

At various times, we have experienced and expect to continue to experience, shortages of some of the electronic components that we use. Some of our component suppliers lack sufficient capacity to meet the demand for these components. In some cases, supply shortages and delays in deliveries of particular components have resulted in curtailed production, or delays in production, of assemblies using that component, which contributed to an increase in our inventory levels and reduction in our gross margins. We expect that shortages and delays in deliveries of some components will continue. If we are unable to obtain sufficient components on a timely basis, we may experience manufacturing delays, which could harm our relationships with current or prospective customers and reduce our sales. We also depend on a small number of suppliers for certain components that we use in our business. If we were unable to continue to purchase components from this group, our business and operating results could be materially and adversely affected.

We may be required to write down our long-lived assets and a significant impairment charge would adversely affect our operating results.

At December 31, 2011, we had $161.3 million in long-lived assets on our balance sheet. The valuation of our long-lived assets requires us to make assumptions about future sales prices and sales volumes for our products. Our assumptions are used to forecast future undiscounted cash flows. Given the current economic environment, uncertainties regarding the duration and severity of these conditions, forecasting future business is difficult and subject to modification. If actual market conditions differ or our forecasts change, we may be required to reassess long-lived assets and we may have to record an impairment charge. Any impairment charge relating to long-lived assets would have the effect of decreasing our earnings or increasing our losses in such period. If we are required to take a substantial impairment charge, our operating results could be materially adversely affected in the periods and year in which the charge is incurred.

The PRC s labor law could penalize Nam Tai if it needs to make additional workforce reductions.

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 provides for an open-ended employment contract for 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 a lifetime, permanent contract, which is terminable by the Company only in specific circumstances, such as a material breach by the employee of the employer s rules and regulations or for a serious dereliction of an employee s duty. Under the new law, a reduction in the workforce of 20% or more may occur only under specific 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. In addition, the new law requires that companies communicate with the labor union of the Company and the District Labor Bureau if the Company terminates the employment of 20 or more people at one time. We can expect to incur much higher costs under China s labor laws if we are forced in the future to downsize our workforce materially and such costs could have a material adverse effect on our financial results and financial condition.

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The economy of China has been experiencing significant growth, leading to inflation and increased labor costs. Any material increases in the labor costs for workers in the PRC may have a material and adverse effect on our financial operating results and profitability.

We generate all revenues from sales of products that we manufacture at our facilities in the PRC. The economy in China has grown significantly over the past 20 years, which has resulted in inflation and an increase in the average cost of labor, especially in the coastal cities. China s consumer price index, the broadest measure of inflation, rose 4.5% in January 2012 from the level in January 2011. The wages we pay our employees also increased substantially in 2011. At December 31, 2011, the average wage level of our direct labour workforce was approximately 27% higher than that at December 31, 2010. China s overall economy and the average wage in the PRC are expected to continue to grow.

Continuing inflation and material increases in the cost of labor in China could diminish our competitive advantage. Unless we are able pass on these increased labor costs to our customers by increasing prices for our products and services, our profitability and results of operations could be materially and adversely affected.

We are exposed to global business trends in the mobile phone industry, which could result in even lower gross margins on mobile phone components and subassemblies we manufacture.

During the year ended December 31, 2011, approximately 88% of our sales were derived from subassemblies and components for mobile phones. Accordingly, any fluctuations in the size of the mobile phone market, market trends, increased competition or pricing pressure in the mobile phone industry may affect our business and operating results. For example, the mobile phone industry has been experiencing rapid growth, particularly from emerging economies such as India and China. The growth in these markets, however, does not necessarily translate into increased margins or growing profits as mobile phones sold in developing countries are typically stripped down to basic features and sold for low prices. Competition in the emerging markets is fierce, even more intense than in developed markets. Accordingly, we expect that our margins and profitability from the components and assemblies we manufacture for use in mobile phones for emerging economies will continue to undergo severe pricing pressures, resulting in lower margins than we have experienced historically.

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

Our customers rely on a variety of carriers for product transportation through various international ports. A work stoppage, strike or shutdown of one or more major ports or airports could result in shipping delays that could materially and adversely affect our customers, our business and our operating results. Similarly, an increase in freight surcharges from rising fuel costs or general price increases could materially and adversely affect our business and operating results.

The political, economic and legal uncertainties involved with operating an international organization could significantly harm us.

As of December 31, 2011, approximately 97.2% of the net book value of our total property, plant and equipment was located in China. We sell our products to customers in Hong Kong, North America, Europe, Japan, China and Southeast Asia. Our international operations are 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;

- limitations on the repatriation of funds because of foreign exchange controls;
- exposure to political and financial instability;
- currency exchange fluctuations, collection difficulties or other country-specific losses;
- exposure to fluctuations in the value of local currencies;
- changes in value-added tax reimbursement;
- imposition of currency exchange controls; and
- delays from customs brokers or government agencies.

Any of these risks could significantly harm our business, financial condition and operating results.

Our operating results could be negatively impacted by seasonality.

Historically, our sales and operating results have been affected by seasonality. Sales of products and components related to mobile phones have generally been lower in the first quarter after peaking in the fourth quarter. Sales of educational products and home entertainment devices are often higher during the second and third quarters in anticipation of the start of the school year and the holiday season. Similarly, orders for consumer electronics products have historically been lower in the first quarter due to the closing of our factories in China for the Lunar New Year holidays and the general reduction in sales following the holiday season. These sales patterns may not be indicative of our future sales performance. For example, in 2009 as a result of the prevailing economic turmoil, many of our customers either postponed or cancelled orders that had been scheduled to be delivered for the holidays, which based on our historical seasonal patterns was unusual.

The long, national seasonal breaks in the PRC, such as the Chinese Lunar New Year holidays during the first quarter, and the National Day Golden week during the fourth quarter, typically adversely affect our ability to manufacture products, obtain components and materials from suppliers and receive and process orders from customers. Accordingly our results of operations during these periods can be expected to suffer.

Our results could be adversely affected with intensifying environmental regulations.

Our operations create environmentally sensitive waste. Our manufacturing process involves the use and disposal of chemicals, solid and hazardous waste and other toxic and hazardous materials. The disposal of hazardous waste has received increasing attention from Chinese national and local governments and foreign governments and agencies and is subject to increasing regulation. Currently, Chinese environmental protection laws and regulations impose fines on the discharge of waste materials and empower certain environmental authorities to close any facility that causes serious environmental problems. The costs of remedying violations or resolving enforcement actions that might be initiated by governmental authorities could be substantial. Any remediation of environmental contamination would involve substantial expense that could harm our operating results. In addition, we cannot predict the nature, scope or effect of future regulatory requirements to which our operations may be subject or the manner in which existing or future laws will be administered or interpreted. Future regulations may be applied to materials, products or activities that have not yet been subject to regulation. The costs of complying with new or more stringent regulations could be significant.

Global environmental legislation continues to emerge. These laws place increased responsibility and requirements on the producers of electronic equipment and, in turn, their EMS providers and suppliers. On July 1, 2006, the European Union s Restriction of Hazardous Substances (RoHS) came into effect. As a result, the use of lead and certain other specific substances in electronic products is restricted in the European Union. Where appropriate, we have transitioned our manufacturing processes and interfaced with suppliers and customers to review and secure RoHS compliance. In the event we are not in compliance with the RoHS requirements, we could incur substantial costs, including fines and penalties, as well as liability to our customers. In addition, our customers who were deemed exempt for certain substances, or beyond the scope of the legislation, are beginning to be impacted by the changing supply chain. In this respect, we may incur costs related to the portion of our inventory that contains these restricted substances. There are also European Union requirements with respect to the collection, recycling and management of electronic product and component waste. Under the European Union s Waste Electrical and Electronic Equipment (WEEE) directive, responsibility rests primarily with OEMs rather than with EMS companies. However, OEMs may turn to EMS companies such as Nam Tai for assistance in meeting their WEEE obligations. Failure by our customers to meet the RoHS or WEEE requirements or obligations could have a negative impact on their businesses and revenues which would adversely impact our financial results. Similar restrictions are being proposed or enacted in other jurisdictions, including China. We cannot currently assess the impact of these legislations on our operations.

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. Sometimes we are given advance notice of power shortages and, in response to the occurrence of power shortages 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.

Our insurance coverage may not be sufficient to cover the risks to our manufacturing facilities or related to our operations.

We have not experienced any major accidents in the course of our operations, which have caused significant property damage or personal injuries. However, there is no assurance that major accidents will not occur in the future. Although we have insurance against various risks, including a business interruption or losses or damages to our buildings, machinery, equipment and inventories, the occurrence of certain incidents such as major earthquakes, hurricanes, tsunamis, war, acts of terrorism, pandemics and flood, and their consequences, we may not be covered adequately, or at all, by our insurance. In the event of a major earthquake or other disaster affecting our manufacturing facilities, our operations and management information systems, which control our worldwide procurement, inventory management and shipping and billing activities, could be significantly disrupted. Such events could also delay or prevent product manufacturing and shipment for the time required to transfer production or repair, rebuild or replace the affected manufacturing facilities. This time frame could be lengthy and result in significant expenses for repair and related costs. Any extended inability to continue our operations at affected facilities following such an event would reduce our revenue and potentially damage our reputation as a reliable supplier.

We also face exposure to product liability claims in the event that any of our products are alleged to have resulted in property damage, bodily injury or other adverse effects. We have limited product liability insurance covering only some of our products. Losses incurred or payments we may be required to make in excess of applicable insurance coverage or for uninsured events or any material claim for which insurance coverage is denied, limited or is not available could have a material adverse effect on our business, operating results or financial condition.

We could become involved in intellectual property disputes.

We do not have any patents, licenses, or trademarks material to our business. Instead, we rely on trade secrets, industry expertise and our customers sharing their intellectual property with us. However, there can be no assurance that the intellectual property of our customers is their intellectual property. We may be notified that we are infringing patents, copyrights 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 such an alternative or obtaining a license on reasonable terms, if at all. Any litigation, even without merit, could result in substantial costs and the diversion of resources and could materially and adversely affect our business and operating results.

We depend on our executive officers and skilled personnel and, if we are unable to attract or retain personnel necessary to operate our business, our ability to perform our services and manufacture and market our products successfully could be harmed.

Our success depends largely upon the continued services of our executive officers as well as upon our ability to attract and retain qualified technical, manufacturing and marketing personnel. Generally, we have entered into employment agreements or non-competition agreements with our executive officers. However, we cannot assure you that we will be able retain our executive officers and we could be seriously harmed by the loss of any of our executive officers. The loss of service of any of these officers or key management personnel could have a material adverse effect on our business growth and operating results. Although we maintain key person life insurance for our executive officers, such coverage may not be adequate to protect us in the event of loss of such personnel. As our operations grow, we also need to recruit and retain additional skilled management personnel and if we are not able to do so, our business and our ability to grow could be harmed.

We have experienced high management and employee turnover at our manufacturing facilities in China, and are experiencing increased difficulty in recruiting employees for these facilities. In addition, we are noting the early signs of wage inflation, labor unrest and increased unionization in China and expect these to be ongoing trends for the foreseeable future, which could cause employee issues, including work stoppages, excessive wage increases and the formation of more active labor unions, at our China facilities. Virtually all of our employees work at our facilities in China, and the costs associated with hiring and retaining these employees has increased over the past several years and particularly during the last two years. The high turnover rate, our difficulty in recruiting and retaining qualified employees and the labor trends in China have resulted in an increase in our employee expenses. A continuation of any of these trends could result in even higher costs and production disruptions or delays, which may result in order cancellations and the imposition of customer penalties. If we were unable to perform manufacturing services and deliver our products on time, it could have a negative impact on our net sales and profitability.

The PRC legal system has inherent uncertainties that could materially and adversely impact our ability to enforce the agreements governing our factories and to do business.

We occupy our manufacturing facilities under China land use agreements with agencies of the PRC government and we occupy other facilities under lease agreements with the relevant landlord. Our operations depend on our relationship with the local governments in the regions which our facilities are located and our landlords. Our operations and prospects could be materially and adversely affected by the failure of the local government to honor these agreements or an adverse change in the law governing them. In the event of a dispute, enforcement of these agreements could be difficult in China. Unlike the United States, China has a civil law system based on written statutes in which judicial decisions have limited precedential value. The government of China has enacted laws and regulations dealing with economic matters such as corporate organization and governance, foreign investment, commerce, taxation and trade. However, its experience in implementing, interpreting and enforcing these laws and regulations is limited, and our ability to enforce commercial claims or to resolve commercial disputes in China is unpredictable. These matters may be subject to the exercise of considerable discretion by agencies of the PRC government, and forces and factors unrelated to the legal merits of a particular matter or dispute may influence their determination.

Political or trade controversies between China and the United States could harm our operating results or depress our stock price.

The United States and PRC governments continue to disagree on some political issues. These occasional controversies could materially and adversely affect our business and operations. Political or trade friction between the two countries could also materially and adversely affect the market price of our shares, whether or not they adversely affect our business.

Changes to PRC tax laws and heightened efforts by the China s tax authorities to increase revenues have subjected us to greater taxes.

Under PRC law before 2008, 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 unified enterprise income tax law or EIT, which became effective on January 1, 2008. Prior to the EIT, as a foreign invested enterprise, or FIE , located in Shenzhen, China, our PRC subsidiaries enjoyed a national income tax rate of 15% and were exempted from the 3% local income tax. The preferential tax treatment given to our subsidiaries in the PRC as a result of reinvesting their profits earned in previous years in the PRC also expired on January 1, 2008. Under the EIT, most domestic enterprises and FIEs will be subject to a single PRC enterprise income tax rate of 25% in 2012 and afterward. For information on the EIT rates as announced by the PRC s State Council for the transition period until year 2012, please see the table in ITEM 5. Operating and Financial Review and Prospects on page 37 of this Report. We base our tax position upon the anticipated nature and conduct of our business and upon our understanding of the tax laws of the various administrative regions and countries in which we have assets or conduct activities. However, our tax position is subject to review and possible challenge by taxing authorities and to possible changes in law, which may have retroactive effect. We cannot determine in advance the extent to which some jurisdictions may require us to pay taxes or make payments in lieu of taxes.

We appear to have been a passive foreign investment company for 2011 and we may also be a passive foreign investment company for 2012, which could result in adverse U.S. federal income tax consequences for U.S. investors.

The determination of whether we are a passive foreign investment company, or PFIC, in any taxable year is made on an annual basis after the close of that year and depends on the composition of our income and the nature and value of our assets, including goodwill. Specifically, we will be classified as a PFIC if, after applying relevant look-through rules with respect to the income and assets of subsidiaries, either (i) 75% or more of our gross income for such taxable year is passive income, or (ii) 50% or more of the value of our assets (based on an average of the quarterly values of the assets during such year) is attributable to assets that either produce passive income or are held for the production of passive income (the PFIC asset test).

Based upon the nature and book value of our assets and the total market value, or market capitalization, of our shares (which reflects goodwill) at the end of each quarter during 2011, we appear to have been a PFIC for U.S. federal income tax purposes for 2011. We have not conducted an appraisal of the actual fair market value of our assets for 2011 or currently in 2012, and we cannot anticipate the market capitalization of our shares for 2012. Accordingly, we may be treated as a PFIC for 2012. Our characterization as a PFIC during any year could result in adverse U.S. federal income tax consequences for U.S. investors. For example, if we were a PFIC in 2011, in 2012 or in any other taxable year, U.S. investors who owned our common shares generally would be subject to increased U.S. tax liabilities and reporting requirements.

Given the complexity of the issues regarding our classification as a PFIC, U.S. investors are urged to consult their own tax advisors for guidance as to our PFIC status. For further discussion of the adverse U.S. federal income tax consequences of from the classification as a PFIC see Taxation United States Federal Income Tax Consequences beginning on page 67 of this Report.

Changes in foreign exchange regulations of China could adversely affect our operating results.

Some of our earnings are denominated in yuan, the base unit of the RMB. The People s Bank of China and the State Administration of foreign Exchange (SAFE) regulate the conversion of RMB into foreign currencies. Under the current unified floating exchange rate system, the People s Bank of China publishes a daily exchange rate for RMB based on the previous day s dealings in the inter-bank foreign exchange market. Financial institutions may enter into foreign exchange transactions at exchange rates within an authorized range above or below the exchange rate published by the People s Bank of China according to the market conditions. Since 1996, the PRC government has issued a number of rules, regulations and notices regarding foreign exchange control designed to provide for greater convertibility of RMB. Under such regulations, any FIE must establish a current account and a capital account with a bank authorized to deal in foreign exchange. Currently, FIEs are able to exchange RMB into foreign exchange currencies at designated foreign exchange banks for settlement of current account transactions, which include payment of dividends based on the board resolutions authorizing the distribution of profits or dividends of the company concerned, without the approval of SAFE. Conversion of RMB into foreign currencies for capital account transactions, which include the receipt and payment of foreign currencies for loans and capital contributions, continues to be subject to limitations and requires the approval of SAFE. There can be no assurance that we will be able to obtain sufficient foreign currencies to make relevant payments or satisfy other foreign currency requirements in the future.

Changes in currency exchange rates involving the Japanese yen or RMB have and could continue to significantly affect our financial results.

Our financial results have been affected by currency fluctuations, resulting in total foreign exchange gains or losses during each of our three fiscal years ended December 31 as indicated in the following chart:

Our operating costs and financial results have been adversely affected by the appreciation of the RMB to the U.S. dollar because operating costs, which include labor costs, are denominated in RMB. Future appreciation of the Japanese yen against the U.S. dollar would increase our costs and could adversely affect our margins and financial results unless we made sufficient sales in Japanese yen to offset the costs and expenses, including material purchases, we incur in Japanese yen.

We sell most of our products in U.S. dollars and pay our expenses in U.S. dollars, Japanese yen, Hong Kong dollars and RMB. While we face a variety of risks associated with changes among the relative value of these currencies, we believe the most significant exchange risk presently results from the costs and expenses we pay in RMB and Japanese yen, and material purchases we make, in Japanese yen.

The appreciation and depreciation of the RMB compared to the U.S. dollar increases and decreases our costs and expenses to the extent paid in RMB, respectively. Approximately 18%, 17% and 19% of our total costs and expenses and 9%, 7% and 9% of our material costs were in RMB during the years ended December 31, 2009, 2010 and 2011, respectively.

Similarly, the appreciation and depreciation of the Japanese yen as compared to the U.S. dollar increases and decreases our costs and expenses to the extent paid in yen, respectively. Approximately 18%, 24% and 5% of our total costs and expenses and 14%, 29% and 6% of our material costs were in Japanese yen during the years ended December 31, 2009, 2010 and 2011, respectively. However, we make substantial sales denominated in Japanese yen, which mitigates the effects of fluctuations in the yen-U.S. dollar exchange ratio on our financial results. Approximately 12%, 23% and 5% respectively, of our total net sales were made in Japanese yen during the years ended December 31, 2009, 2010 and 2011, respectively.

A future material appreciation of the Japanese yen against the U.S. dollar would increase our costs when translated into U.S. dollars and could adversely affect our margins and financial results unless we made sufficient sales in Japanese yen to offset against material purchases and other costs we paid in Japanese yen.

If we pass the effect of increases in the RMB and/or Japanese yen relative to the U.S. dollars to our customers through price increases it would make our products more expensive. This could result in the loss of customers, who may seek, and be able to obtain, products and services comparable to those we offer in lower-cost regions of the world. If we did not increase our prices to pass on the effect of increases in the RMB or Japanese yen relative to the U.S. dollars, our margins and profitability could suffer.

Nam Tai s declaration and payment of dividends is not assured. We declared no dividends for 2009 and 2010. Although our Board has resumed dividends for 2011 and 2012, we may not declare or pay dividends thereafter.

Before 2009, we had a long history of paying dividend. In February 2009, our board of directors decided not to declare a dividend. In February 2010, our board of directors also decided not to declare a dividend. The board of directors decided not to declare a dividend in 2009 and 2010 in order to maintain our cash reserves during a period of global economic turmoil. The Company resumed the payment of quarterly dividends of $0.05 and $0.07 per share for 2011 and 2012 respectively. The payment of dividends in 2011 and 2012 does not necessarily mean that dividend payments will continue thereafter. Whether future dividends will be declared will depend on our future growth and earnings and our cash flow needs for future expansion. Our growth, earning or cash flow needs may be adversely affected by one or more of the factors discussed in this section of our Report or by other factors. There can be no assurance that cash dividends on the Company s shares will be declared for years after 2012, 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. For additional information on the dividends we have declared for 2012 and historically, please see ITEM 8. Dividends on page 62 of this Report.

Payment of dividends by our subsidiaries in the PRC to our subsidiaries outside of the PRC and to us, as the ultimate parent, is subject to restrictions under PRC law. If we determine to continue our payment of dividends to our shareholders, the PRC tax law could force us to reduce the amount of dividends we have historically paid to our shareholders or possibly eliminate our ability to pay any dividends at all.

Under PRC law, dividends may only be paid 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 we are 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 a dividend in a given year as determined under U.S. GAAP. China s tax authorities may also change the determination of income which would limit our PRC subsidiaries ability to pay dividends and make other distributions.

Prior to the EIT law, which became effective on January 1, 2008, PRC-organized companies were exempt from withholding taxes with respect to earnings distributions, or dividends, paid to shareholders of PRC companies outside the PRC. 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 5% to 15% by way of withholding unless the foreign investors are companies incorporated in countries which have tax treaty agreements with the PRC and then the rate agreed by both parties will be applied. For example, under the terms of the tax treaty between Hong Kong and the PRC, which became effective in December 2006, distributions from our PRC subsidiaries to our Hong Kong subsidiary, will be subject to a withholding tax at a rate ranging from 5% to 10%, depending on the extent of ownership of equity interests held by our Hong Kong subsidiary in our PRC enterprises. 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.

The market price of our shares will likely be subject to substantial price and volume fluctuations.

The markets for equity securities have been volatile and the price of our common shares has been and could continue to be subject to wide fluctuations in response to variations in our operating results, news announcements, trading volume, sales of common shares by our officers, directors and our principal shareholders, customers, suppliers or other publicly traded companies, general market trends both domestically and internationally, currency movements and interest rate fluctuations. Other events, such as the issuance of common shares upon the exercise of our outstanding stock options could also materially and adversely affect the prevailing market price of our common shares.

Further, the stock markets have often experienced extreme price and volume fluctuations that have affected the market prices of the equity securities of many companies and that have been unrelated or disproportionate to the operating performance of such companies. These fluctuations may materially and adversely affect the market price of our common shares.

Our senior management owns a large portion of our common stock allowing them to control or substantially influence the outcome of matters requiring shareholder approval.

On February 28, 2012, members of our senior management and board of directors as a group beneficially owned approximately 25.0% of our common shares. As a result, acting together, they may be able to control and 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 Nam Tai, or causing a change in control of Nam Tai that may not be favored by our other shareholders.

Regulatory initiatives in the United States, such as the Dodd-Frank Act and the Sarbanes-Oxley Act have increased, and may continue to increase the time and costs of being a U.S. public company and any further changes would likely continue to increase our costs.

In the United States, changes in corporate governance practices due to the Dodd-Frank Act and the Sarbanes-Oxley Act, changes in the continued listing rules of the New York Stock Exchange, new accounting pronouncements and new regulatory legislation, rules or accounting changes have increased the cost of being a U.S. public company and may have an adverse impact on our future financial position and operating results. These regulatory changes and other legislative initiatives have made some activities more time-consuming and have increased financial compliance and administrative costs for public companies, including foreign private issuers like Nam Tai. In addition, any future changes in regulatory legislation, rules or accounting may cause our legal and accounting costs to further increase. In addition, these new rules and regulations require increasing time commitments and resource commitments from our company, including from senior management. This increased cost could negatively impact our earnings and have a material adverse effect on our financial position results of operations.

Due to inherent limitations, there can be no assurance that our system of disclosure and internal controls and procedures will be successful in preventing all errors or fraud, or in informing management of all material information in a timely manner.

Our management, including the Acting Chief Executive Officer and the Chief Financial Officer, does not expect that our disclosure controls and internal controls and procedures will prevent all errors and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system reflects that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been or will be detected. These inherent limitations include the realities that judgments in decision-making can be faulty and that breakdowns can occur simply because of error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control.

The design of any system of controls is also based in part upon certain assumptions about the likelihood of future events. There can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Over time, a control may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur or may not be detected.

There are inherent uncertainties involved in estimates, judgments and assumptions used in the preparation of financial statements in accordance with U.S. GAAP. Any changes in estimates, judgments and assumptions could have a material adverse effect on our business, financial position and results of operations.

The consolidated financial statements included in the periodic reports we file with the SEC are prepared in accordance with U.S. GAAP. The preparation of financial statements in accordance with U.S. GAAP involves making estimates, judgments and assumptions that affect reported amounts of assets (including intangible assets), liabilities and related reserves, revenues, expenses and income. Estimates, judgments and assumptions are inherently subject to changes in the future, and any such changes could result in corresponding changes to the amounts of assets, liabilities, revenues, expenses and income. Any such changes could have a material adverse effect on our financial position and results of operation.

It may be difficult to serve us with legal process or enforce judgments against our management or us.

We are a British Virgin Islands holding corporation with subsidiaries in Hong Kong and China. Substantially, all of our assets are located in the PRC. In addition, most of our directors and executive officers reside within the PRC or Hong Kong, and substantially all of the assets of these persons are located within the PRC or Hong Kong. It may not be possible to effect service of process within the United States or elsewhere outside the PRC or Hong Kong upon our directors, or executive officers, including effecting service of process with respect to matters arising under United States federal securities laws or applicable state securities laws. The PRC does not have treaties providing for the reciprocal recognition and enforcement of judgments of courts with the United States and many other countries. As a result, recognition and enforcement in the PRC of judgments of a court in the United States or many other jurisdictions in relation to any matter, including securities laws, may be difficult or impossible. An original action may be brought against our assets and our subsidiaries, our directors and executive officers in the PRC only if the actions are not required to be arbitrated by PRC law and only if the facts alleged in the complaint give rise to a cause of action under PRC law. In connection with any such original action, a PRC court may award civil liability, including monetary damages.

No treaty exists between Hong Kong or the British Virgin Islands and the United States providing for the reciprocal enforcement of foreign judgments. However, the courts of Hong Kong and the British Virgin Islands are generally prepared to accept a foreign judgment as evidence of a debt due. An action may then be commenced in Hong Kong or the British Virgin Islands for recovery of this debt. A Hong Kong or British Virgin Islands court will only accept a foreign judgment as evidence of a debt due if:

- the judgment is for a liquidated amount in a civil matter;

- the judgment is final and conclusive;

the judgment is not, directly or indirectly, for the payment of foreign taxes, penalties, fines or charges of a like nature (in this regard, a Hong Kong court is unlikely to accept a judgment for an amount obtained by doubling, trebling or otherwise multiplying a sum assessed as compensation for the loss or damage sustained by the person in whose favor the judgment was given);

the judgment was not obtained by actual or constructive fraud or duress;

the foreign court has taken jurisdiction on grounds that are recognized by the common law rules as to conflict of laws in Hong Kong or the British Virgin Islands;

the proceedings in which the judgment was obtained were not contrary to natural justice (i.e. the concept of fair adjudication);

the proceedings in which the judgment was obtained, the judgment itself and the enforcement of the judgment are not contrary to the public policy of Hong Kong or the British Virgin Islands;

the person against whom the judgment is given is subject to the jurisdiction of a foreign court; and

the judgment is not on a claim for contribution in respect of damages awarded by a judgment, which fall under Section 7 of the Protection of Trading Interests Ordinance, Chapter 7 of the Laws of Hong Kong.

Enforcement of a foreign judgment in Hong Kong or the British Virgin Islands may also be limited or affected by applicable bankruptcy, insolvency, liquidation, arrangement and moratorium, or similar laws relating to or affecting creditors rights generally, and will be subject to a statutory limitation of time within which proceedings may be brought.

Future issuances of preference shares could materially and adversely affect the holders of our common shares or delay or prevent a change of control.

Our Board of Directors may amend our Memorandum and Articles of Association without shareholder approval 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). While we have never issued any preference shares and we have none outstanding, we could issue preference shares in the future. Future issuance of preference shares could materially and adversely affect the rights of the holders of our common shares, or delay or prevent a change of control.

We incurred substantial expenses and costs in privatizing Nam Tai Electronic & Electrical Products Limited. It may require a number of years to realize the benefits from owning 100% of NTEEP.

In November 2009, we successfully completed the privatization of Nam Tai Electronic & Electrical Products Limited, or NTEEP, by tendering for and acquiring the 25.12% of NTEEP that we did not previously own. As a result of the acquisition, NTEEP became our wholly owned subsidiary. During the year ended December 31, 2009, we expended approximately $44.3 million to acquire NTEEP s noncontrolling shares, including approximately $0.9 million in professional fees and related expenses. We financed these expenditures with internally generated funds.

Although our acquisition of NTEEP has resulted in cost savings and the elimination of profit sharing with NTEEP s noncontrolling shareholders, which improved our financial results during the years ended December 31, 2010 and 2011, we will only benefit from this acquisition to the extent NTEEP s operations remain profitable. Even if NTEEP s future operating results remain profitable, it may take a number of years before NTEEP s net income that was attributable to the noncontrolling interests and the overhead costs saved from NTEEP s privatization equal the costs and expenses of acquiring that interest.

Our status as a foreign private issuer in the United States exempts us from certain of the reporting requirements under the Securities Exchange Act of 1934 and corporate governance standards of the New York Stock Exchange, or NYSE limiting the protections and information afforded to investors.

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

the rules under the Exchange Act requiring the filing with the SEC of quarterly reports on Form 10-Q, current reports on Form 8-K or annual reports on Form 10-K;

the sections of the Exchange Act regulating the solicitation of proxies, consents or authorizations in respect of a security registered under the Exchange Act or disclosures required in a proxy statement in accordance with rules therefor promulgated under the Exchange Act;

the provisions of Regulation FD aimed at preventing issuers from making selective disclosures of material information; and

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).

In addition, because the Company is a foreign private issuer, certain corporate governance standards of the NYSE that are applied to domestic companies listed on that exchange may not be applicable to us. For information regarding whether our corporate governance standards differ from those applied to US domestic issuers, see the discussion under NYSE listed Company Manual Disclosure in ITEM 6. Directors and Senior Management of this Report.

Because of these exemptions, investors are not afforded the same protections or information generally available to investors holding shares in public companies organized in the United States or traded on the NYSE. See footnote * on page 52 of this Report under the heading Compensation on an Individual Basis for information and risks associated with disclosures we have made in this Report or may make in our proxy statements regarding compensation we have paid to our directors and senior managers on an individual basis.

Product quality issues could adversely affect our reputation and could impact our operating results.

The market for our products is characterized by rapidly changing technology and evolving industry standards. To remain competitive, we must continually introduce new manufacturing solutions. The products that we sell could contain defects in design or manufacture. Defects could also occur in the products or components that are supplied to us. There can be no assurance we will be able to detect and remedy all defects in the products we sell. Failure to do so could result in product recalls, product redesign efforts, lost revenue, loss of reputation, and significant warranty and other expenses to remedy.

ITEM 4. INFORMATION ON THE COMPANY

Corporate Information

Nam Tai Electronics, Inc. was founded in 1975 and moved its manufacturing facilities to China in 1980 to take advantage of lower overhead costs, lower material costs and competitive labor rates available. We relocated to Shenzhen, China in order to capitalize on the significant opportunities offered in southern China. We were reincorporated as a limited liability International Business Company under the laws of the British Virgin Islands in August 1987 (which was amended in 2004 as The British Virgin Islands Business Companies Act, 2004). Our PRC headquarters and our principal manufacturing and design operations are currently based in Shenzhen, China, approximately 30 miles from Hong Kong. Certain of our subsidiaries offices are located in Hong Kong, which provide us access to Hong Kong s infrastructure of communication and banking facilities. Our corporate administrative matters are conducted in the British Virgin Islands through our registered agent, McNamara Corporate Services Limited, McNamara Chambers, P.O. Box 3342, Road Town, Tortola, British Virgin Islands. In 1978, Mr. Koo, the founder of the Company, began recruiting operating executives from the Japanese electronics industry. These executives brought years of experience in Japanese manufacturing methods, which emphasize quality, precision, and efficiency in manufacturing. A large portion of our senior and middle management currently includes Japanese professionals who provide technical expertise and work closely with both our Japanese component suppliers and customers.

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Major Events during 2011 to Date

During 2011, to simplify our corporate structure, we have taken the following actions:

- Changing the name of Namtai Electronic (Shenzhen) Co., Ltd to Namtai Investment (Shenzhen) Co., Ltd (NTISZ) and transforming it into an investment holding company in the PRC in April 2011;
- Changing the shareholder of NTISZ from Nam Tai Electronic & Electrical Products Limited to Nam Tai Electronics, Inc. in April 2011;
- Changing the shareholder of Wuxi Zastron Precision-Flex Co., Ltd. (Wuxi Zastron-Flex) from Nam Tai Investment Limited to NTISZ in July 2011;
- Changing Zastron Electronic (Shenzhen) Co., Ltd from a domestic enterprise to a wholly owned foreign enterprise in August 2011; and
- Based on a strategic development agreement, Wuxi Zastron-Flex was recapitalized with an injection of $32.3 million by NTISZ in August, October and November 2011.

Organizational Structure

The chart as below and on the next page shows our organizational structure of our principal subsidiaries at December 31, 2011.

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Capital Expenditures

The following chart illustrates the amounts of our principal capital expenditures and divestitures (in thousands of dollars) during each of the past three years ended December 31:

Expenditures on property, plant and equipment

The following are capital expenditures we currently have planned for 2012:

- $43.4 million for a TFT LCD module assembly line;
- $7.7 million for setting up equipment and machinery for flex rigid boards manufacturing; and
- $5.0 million for land and building construction.

Our major capital expenditures in 2011 included:

- $64.9 million for machinery and lease hold improvements for a LCD module assembly;
- $7.0 million for machinery used for FPC boards and assemblies; and
- $4.6 million for commercial property in Hong Kong.

Our major capital expenditures in 2010 included:

- $3.2 million for machinery used mainly for the production of LCD and FPC Modules;
- $0.9 million for leasehold improvements as a result of two of our subsidiaries merging; and
- $0.5 million for other capital equipment.

Our major capital expenditures in 2009 included:

- $23.7 million for new factory construction in Wuxi;
- $0.5 million for machinery mainly used for the production of LCD modules; and

$0.8 million for other capital equipment.

Our plans for capital expenditures are subject to change from time to time and could result from, among other things, our consummation of any significant acquisition or strategic investment opportunities, which we regularly explore, and prevailing economic conditions.

Business Overview

We are an electronics manufacturing and design services provider to a select group of the world s leading telecommunications and consumer electronic products OEMs. Through our EMS operations, we manufacture electronic components and subassemblies, including FPC boards, FPC board subassemblies, LCD panels, LCD modules, TFT display modules, RF modules, DAB modules, internet radio subassemblies, CMOS imaging sensor modules and PCB subassemblies. The components, modules and subassemblies are used in numerous electronic products, including mobile phones, IP phones, notebook computers, digital cameras, electronic toys, handheld video game devices and learning devices. We also manufacture finished products, including mobile phone accessories, home entertainment products and educational products. We assist our OEM customers in the design and development of their products and furnish full turnkey manufacturing services that utilize advanced manufacturing processes and production technologies.

Our services include software, firmware, and hardware development, mechanical design, parts and components source and purchasing, product industrialization, and assembly into finished products or electronic subassemblies with full quality testing and assurance. These services are value-added and assist us in obtaining new business but do not represent a material component of our revenues. We also provide early supplier involvement in design service to develop proprietary products that are sold by our OEM customers using their brand name.

Our Customers

Historically, we have had substantial recurring sales from our existing customers. Approximately 99.2% of our 2011 net sales came from customers we provided services to in 2010. While we seek to diversify our customer base, a small number of customers currently generate a significant portion of our sales. Sales to our 10 largest customers accounted for 86.2%, 88.4% and 93.0% of our net sales during the years ended December 31, 2009, 2010 and 2011, respectively. Sales to customers accounting for 10% or more of our net sales in the years ended December 31, 2009, 2010 or 2011 (listed in order of our net sales during 2011) were as follows:

	Year ended December 31,		
	2009	2010	2011
Toshiba Mobile Display(1)	12.2%	24.7%	32.3%
Sony Mobile Display Corporation	*	16.7%	30.7%
Sharp Corporation	17.9%	11.9%	10.5%
Sony Computer Entertainment Europe Ltd.	10.2%	17.7%	10.4%
Epson Imaging Devices Corporation	23.0%	*	*

* Less than 10% of our total net sales during the year indicated.

(1) For the years ended December 31, 2009, 2010 and 2011, sales to Toshiba Mobile Display through an agent, Hikari Alphax Co., Ltd, represented 12.2%, 24.1% and 6.9% of net sales, respectively.

Our 10 largest OEM customers based on net sales during 2011 were the following (listed alphabetically):

Customer	Products
Anoto AB	Digital Pen
Flextronics (Nan Jing) Technology Co., Ltd.	LCD modules
Ryoyo Electro Hong Kong Limited	LCD modules
Sharp Corporation	LCD modules, FPC subassemblies and PCB modules
Siemens Enterprise Communications	LCD modules
Sony Computer Entertainment Europe Ltd.	Home entertainment products
Sony Mobile Display Corporation	LCD modules
Stanley Electric (Asia Pacific) Ltd.	LCD Panels for Automotive
Toshiba Mobile Display	LCD modules
Vtech Communications Ltd.	LCD modules

At any given time, different customers account for a significant portion of our business. Percentages of net sales to customers vary from quarter to quarter and from year to year and fluctuate depending on the timing of production cycles for particular products.

Sales to our OEM customers are based primarily on purchase orders we receive from time to time rather than fixed, long-term purchase commitments from our customers. Although it is our general practice to purchase raw materials only upon receiving a purchase order, for certain customers we will occasionally purchase raw materials based on such customers rolling forecasts. Uncertain economic conditions and our general lack of long-term purchase commitments with our customers make it difficult for us to predict revenue accurately long term. Even in those cases where customers are contractually obligated to purchase products from us or repurchase unused inventory from us, we may elect not to enforce our contractual rights immediately because of the long-term relationships and for other business reasons. Instead we may negotiate accommodations with customers regarding particular situations.

Our Products

In 2008 and 2009, we managed our business using three reportable segments: telecommunication components assembly (TCA), consumer electronics and communication products (CECP) and LCD products (LCDP). In 2010, we reclassified the TCA and LCDP segments into the TCA segment to accurately reflect the nature and management of our operations. Currently, the Company operates and presents two business segments: TCA and CECP. The segment information in 2008 and 2009 has been restated in order to conform to the change in segment reporting in accordance with FASB ASC 280-10-50-34. The results of the former LCDP segment were included in the TCA segment in 2008 and 2009.

The TCA segment is focused on subassemblies of components such as LCD modules, radio frequency modules, digital audio broadcast modules, FPC subassemblies, FPC boards, and front light panels and back light panels for handheld video game devices. In addition, we manufacture LCD panels and LCD modules for various electronic appliances. The CECP segment is focused on the manufacturing of box-built products such as mobile phone accessories, entertainment devices, educational products and optical devices.

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Our net sales by reportable segments were as follows ($ in thousands):

	Year ended December 31,					
	2009		2010		2011	
	Dollars	Percent	Dollars	Percent	Dollars	Percent
TCA	292,074	72%	401,259	75%	527,894	88%
CECP	116,063	28%	133,161	25%	74,423	12%
Total	408,137	100%	534,420	100%	602,317	100%

Please refer to Note 15 Segment Information of our consolidated financial statements and ITEM 8. Financial Information Export Sales which sets forth the information of net sales to customers by geographical area.

Consumer Electronic and Communication Products

The consumer electronic and communication products we manufacture are focused on high growth and mass volume product segments of the consumer electronics and communications sectors, and include:

Mobile phone accessories such as headsets containing Bluetooth wireless technology, snap-on portable music speakers, phone cradles, snap-on FM radio adaptors, and snap-on GPS adaptors;

Entertainment devices such as USB webcams for interactive games, USB microphone and converter boxes for Karaoke, and a buzzer device for quiz games, both in wire and wireless designs with an infrared solution;

Educational products such as digital pens, calculators and electronic dictionaries; and

Optical devices such as CMOS imaging sensor modules for notebook computers, portable media players and recording cameras for the automotive industry.

Telecommunication Component Assembly

We manufacture the following subassemblies and components:

Color and monochrome LCD modules to display information as part of telecommunication products such as PDA phones, smart phones and traditional mobile phones and telephone systems. These modules are also used in most other hand-held consumer electronic devices, such as electronic games, MP3 players, Automotive products and digital cameras;

RF modules for integration into mobile phones. RF modules are partially finished circuits that can be incorporated into larger products or components. Each module includes receivers, transmitters, and transceivers, and can be manufactured for use in hand-held consumer electronic products, such as PDAs, laptop computers and other products with wireless connectivity;

DAB modules are digital audio broadcasting components that are used in digital radio products such as home tuners, kitchen radios, in-car receivers, CD players, clock radios, boom boxes, midi-systems and handheld portable devices;

FPC subassemblies for integration into various LCD modules and electronic devices;

FPC board manufacturing for vertical integration to the FPC subassembly business, which are used for mobile phones, PDAs, office automation, laptop computers and other products that require a portable product design;

Front light panels for handheld video game devices;

Back light panels for handheld video game devices;

1.9 high-frequency cordless telephones and home feature phones;

Super high contrast monochrome vertical aligned Twisted Nematic LCD for applications in automotive parts and major appliances; and

Wide temperature monochrome Super-Twisted Nematic (STN) LCD for application in major appliances.

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Our Manufacturing and Assembly Capabilities

We utilize the following production techniques:

Chip on Glass, or COG	a process that connects integrated circuits directly to LCD panels without the need for wire bonding. We apply this technology to produce advanced LCD modules for high-end electronic products, such as cellular phones and PDAs. These machines provide an LCD with a length of up to 200 millimeters by a width of up to 200 millimeters by a height of up to 2.2 millimeters, a process time of five seconds per chip, a pin pitch fine to 38 micrometers. During 2005, our subsidiary, Jetup also started manufacturing COG LCD modules. During 2010, Jetup was merged into Zastron Shenzhen. During the third quarter of 2011, Wuxi Zastron-Flex also expanded LCD module assembly and set up state of the art COG machines. As of December 31, 2011, Zastron Shenzhen and Wuxi Zastron-Flex had a total of 22 sets of COG machines. and is capable of bonding 10 million units of COG LCD modules a month with an accuracy of five microns tolerance, in a cycle time of 12-15 seconds per piece.
Chip on Board, or COB	a technology that utilizes wire bonding to connect large-scale integrated circuits directly to printed circuit boards. As of December 31, 2011, we had 11 COB aluminum bonding machines which provide a high speed chip bonding time of 0.25 second per 2 millimeters wire, a bond pad fine to 75 micrometers and a total production capacity of up to 3,829,000 (150 wires/board) per month. We use COB aluminum bonding in the assembly of consumer products such as digital pens, calculators, electronic dictionaries and audio products. We also had three COB gold ball bonding machines, which provide a high speed chip bonding time of 0.072 second per 2 millimeters wire, a bond pad fine to 50 micrometers and a total production capacity of up to 500,000 (150 wires/board) per month. We use COB gold ball bonding in CMOS camera modules, which are incorporated into USB cameras, notebook computers, mobile phones and digital pens.
Tape Automated Bonding With Anisotropic Conductive Film, or TAB With ACF	an advanced heat sealing technology that connects a liquid crystal display component with an integrated circuit in very small LCD modules, such as those used in cellular phones and pagers. As of December 31, 2011, Zastron Shenzhen had 33 systems of TAB with ACF machines. The machines provide a process time of 10 to 25 seconds per component, a pin pitch fine up to 150 micrometers and a total production capacity of up to 5,876,000 components per month. Zastron Shenzhen is able to bond LCD panels with a length of up to 120 millimeters by a width of up to 120 millimeters and a height of up to 2.2 millimeters, with an accuracy of 10 microns tolerance in a cycle time of 20-25 seconds per piece.
Fine Pitch Heat Seal Technology, or FPHS Technology	allows us to connect LCD displays to PCBs produced by COB and outer lead bonding that enables very thin connections. This method is highly specialized and is used in the production of finished products such as PDAs. As of December 31, 2011, we had eight machines utilizing FPHS technology. The machines provide a pin pitch fine to 260 micrometers and a total production capacity of up to 268,000 units per month.

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Surface Mount Technology, or SMT	a process by which electronic components are mounted directly on both sides of a printed circuit board, increasing board capacity, facilitating product miniaturization and enabling advanced automation of production. We use SMT for products such as mobile display modules and electronic linguistic devices. As of December 31, 2011, we had 30 SMT productions lines. The production time per chip ranges from 0.055 second per chip to 0.8 second per chip and high precision ranging from +/-0.05 millimeter to +/-0.1 millimeter. The components size ranges from 0.4 millimeter long by 0.2 millimeter wide to 55 millimeters long by 55 millimeters wide. Ball grid array, or BGA, ball pitch is 0.4 millimeter and ball diameter is 0.2 millimeter. Flip Chip, our smallest lead/bump pitch, is 250/240UM and our smallest components spacing is 0.15 micrometers. The total production capacity is over 1 billion resistor capacitor chips per month.
Super-Twisted Nematic, or STN, Displays	a type of monochrome passive matrix LCD capable of providing higher information content to display systems. STN Displays are typically found in applications such as cordless phones, mobile phones, MP3 players, pocket games and PDAs. Our subsidiary, Zastron Shenzhen, through its predecessor, Jetup, began producing STN LCDs in 2002. Since 2005, our two existing twisted nematic, or TN type, LCD lines have been upgraded to STN LCD lines. TN displays rotate the director of the liquid crystal by 90 degrees, but STN LCD displays employ up to a 270 degree rotation. This extra rotation gives the crystal a much steeper voltage-brightness response curve and also widens the angle at which the display can be viewed before losing much contrast. As of December 31, 2011, Zastron Shenzhen was using two automated STN lines capable of producing both TN and STN type LCDs with capacity of 100,000 pairs of glass (each sheet of glass of 360 millimeters by 400 millimeters in size) panels per month.
LCD Back-End	a main manufacturing process for LCD panels, and is regarded as part of the process for its finished product LCD modules. It includes the precise pure water cleaning process, scribing of LCD glass, liquid crystal insertion, sealing process and breaking process, then turns the LCD mother glass into LCD panels. Our machines can cope with 0.2 millimeters + 0.2 millimeters LCD mother glass up to dimension of 550 millimeters by 670 millimeters, with cutting tolerance +/-0.1 millimeters.

As of December 31, 2011, we had 18 clean rooms (total area size of 214,438 square feet) at our principal manufacturing facilities, which housed COB, COF, COG and Chip Scale Package capabilities for CMOS sensor modules, electronic calculators, digital camera accessories, LCD panels and modules manufacturing, and FPC manufacturing.

A clean room is an environment, typically used in manufacturing or scientific research, which has a low level of environmental pollutants such as dust, airborne microbes, aerosol particles and chemical vapors. In other words, a clean room has a controlled level of contamination that is specified by the number of particles per cubic meter at a specified particle size. Of our 18 clean rooms at December 31, 2011, 2 were class one hundred thousand, 7 were class ten thousand, 8 were class thousand and 1 was class one hundred with one of them used for cleaning attire provided for use in the clean rooms.

FPC boards and FPC Subassemblies

Flexible Printed Circuit Subassemblies. We began manufacturing FPC subassemblies in March 2003 for integration into various LCD modules. FPC subassemblies are FPC boards enhanced by attaching electronic components, such as connectors, switches, resistors, capacitors, light emitting devices, integrated circuits, cameras and optical sensors, to the circuit. The reliability of FPC component assemblies is dependent upon proper assembly design and the use of appropriate fixtures to protect the flex-to-connector interface. Connector selection is also important in determining the signal integrity of the overall assembly and is very important to devices that rely upon high system speed to function properly.

Flexible Printed Circuits. Flexible printed circuits, which consist of copper conductive patterns that have been etched or printed while affixed to flexible substrate materials such as polyimide or polyester, are used to provide connections between electronic components and as a substrate to support these electronic devices. The circuits are manufactured by subjecting the base materials to multiple processes, such as drilling, screening, photo imaging, etching, plating and finishing. Single-sided flexible printed circuits, which have an etched conductive pattern on one side of the substrate, are normally less costly and more flexible than double-sided flexible printed circuits because their construction consists of a single patterned conductor layer. Double-sided flexible printed circuits, which have conductive patterns or materials on both sides of the substrate that are interconnected by a drilled or copper-plated hole, can provide either more functionality than a single-sided flexible printed circuit by containing conductive patterns on both sides, or greater shielding of components against electromagnetic interference than a single-sided flexible printed circuit by covering one side of the circuit with a shielding material rather than a circuit pattern.

FPC Boards. Flexible printed circuit boards or FPC Boards are applied to various electronic devices because of their mechanical characteristics and are indispensable to electronic devices requiring system miniaturization, weight reduction and multi-functionality. FPCs are employed in a wide variety of applications due to the nature of their characteristics. Examples of applications for FPCs include cell-phone liquid crystal display enclosures, hinge parts, keypads, battery enclosures and interface components. FPCs fall into three broad categories: single-sided flexible printed wiring boards, double-sided flexible printed wiring boards and multilayer flexible printed boards. Single sided and double sided FPCs are widely employed for personal computers, hard disk drives and cell phones.

We buy a portion of the FPC boards that we use in the manufacturing of our products from suppliers and attach electronic components to the purchased FPC boards in accordance with our customer s specifications and produce FPC subassemblies. Since 2007, we also began manufacturing these devices at our existing facility in Shenzhen to vertically integrate this process by producing FPC boards internally. Our Wuxi factory began manufacturing pilot runs of FPC boards and is moving to large scale manufacturing in 2010**.**

Quality Control

We maintain strict quality control programs for our products, including the use of total quality management systems and advanced testing and calibration equipment. Our quality control personnel test the quality of incoming raw materials and components. During the production stage, our quality control personnel also test the quality of our work-in-progress at several points in the production process. Finally, after the assembly stage, we conduct testing of finished products. In addition, we provide office space at our principal manufacturing facilities for representatives of our major customers to permit them to monitor production of their products and we provide them with direct access to our manufacturing personnel.

All of our existing manufacturing facilities are certified under ISO 9001 quality standards, the International Organization for Standardization, or ISO s, highest standards. The ISO is a Geneva-based organization dedicated to the development of worldwide standards for quality management guidelines and quality assurance. Our certifications under an ISO 9001 quality standard demonstrate that our manufacturing operations meet the most demanding ISO standards. All of our manufacturing facilities are also certified under an ISO 14001 environmental management standard, which was published in 2004 to provide a structured basis for environmental management control.

After the consolidation of our Shenzhen operations under Zastron Shenzhen in 2010, our quality assurance personnel embarked to integrate all management systems in Shenzhen into that single company. At the end of February 2012, Zastron Shenzhen has passed the following certifications:

ISO 9001:2008	Basic Quality Management System
ISO 14001:2004	Environmental Management System
QC080000:2005	Hazardous Substance Process Management System
OHASA18001:2007	Occupational Health & Safety Management System
TS16949:2009	Quality Management System specific for Automotive Products
ISO13485:2003	Quality Management System specific for Medical Products

In December 2009, our new factory in Wuxi was audited for compliance of ISO 9001 and TS16949. We received both certifications in March 2010. During 2010, we applied for other certifications for this plant, including QC08000 and ISO 14001, which we received in April and May 2010, respectively.

We employ the Six Sigma approach in various projects that we run each year. In 2004, our principal manufacturing facilities in Shenzhen were recognized by the Chinese Government as a National Advanced Enterprise for the Promotion of Six Sigma . Six Sigma is an internationally recognized approach that uses facts and data to develop better solutions, thereby reducing defects and production times, and improving customer satisfaction. This approach allows the Company to lower its costs by minimizing manufacturing defects. Our use of Six Sigma has resulted in improved profit margins and higher competitiveness.

Our Suppliers

We purchase thousands of different component parts from numerous suppliers, which we have approved based on their quality, cost and services. For some components, we have chosen, for strategic reasons, to rely on a single supplier. We purchase components from suppliers located in Japan, China and other countries. Our general practice is to purchase components upon receipt of purchase orders from customers and pursuant to the customer s authorization in order to minimizing our inventory risk. However, we may occasionally purchase raw materials or request suppliers to maintain buffer stock of certain supplies for particular customers based on such customer s rolling forecasts in order to

shorten the lead-time for key materials.

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The major component parts we purchase include the following:

Integrated circuits or chips , most of which we purchase presently from Cambridge Silicon Radio Plc Ltd., Qualcomm CDMA Technologies Asia Pacific Pte. Ltd., Toshiba Electronics (Asia) Ltd., Ricoh Co., Ltd., ATI Technologies Ltd., Rohm Electronics (HK) Co., Ltd., Samsung Electronics., Ltd., Sharp Electronics (M) SDN.BHD and certain of their affiliates;

LCD panels, which are available from many manufacturers. Since 2007, we have purchased LCD panels from Suzhou Epson Co., Ltd., Safaring Technology Co., Ltd., Toshiba Matsushita Display Co., Ltd., Shantou Goworld Display (Plant II) Co., Ltd., and VBest Electronics Ltd.;

FPC boards, which consist of copper conductive patterns that have been etched or printed while affixed to flexible substrate materials such as polyimide or polyester, are mainly used to provide connections for electronic components and as a substrate to support these electronic devices. Since 2007, we have purchased FPC boards mainly from Sony Chemical Co., Ltd., Nitto Denko (HK) Co., Ltd. and NOK Mektec Corp. Ltd.;

Light-emitting diodes, or LEDs, are semiconductor devices that emit incoherent narrow-spectrum light when electrically biased in the forward direction. This effect is a form of electroluminescence. LEDs are small extended sources with extra optics added to the chip, which emit a complex intensity spatial distribution. We purchase LEDs primarily from Nichia Corporation and Everlight Electronics Co., Ltd.; and

CMOS imaging sensors, which we purchase mainly from Omnivision Technologies Inc., Micron Technology Inc. and MagnaChip Semiconductor Ltd. Solar cells and batteries, which are standard off-the-shelf items that we generally purchase in Hong Kong from agents of Japanese manufacturers or directly from companies in China; various mechanical components such as plastic parts, cables, rubber keypads, PCBs, indium tin oxide, or ITO, glass used in the production of LCD panels, and packaging materials from various local suppliers in China; and various acoustic components, which we mainly sourced from Wanstonic Electronics Ltd, Yinpin Electronics (SZ) Co., Ltd., Goertek Technology Co., Ltd., Shandong Gettop Acoustic Co., Ltd. and Vansonic Enterprise Co., Ltd.

Whenever practical, we will consider using domestic Chinese suppliers who are often able to provide their products at lower cost than overseas suppliers and with shorter lead times.

From time to time, there may be certain components subjected to limited allocation by certain of our suppliers due to industry-wide shortage as a result of fast growing global demand.

In some cases, supply shortages and delays in deliveries of particular components could result in curtailed production, or delays in production. These supply shortages have contributed to an increase in our inventory levels and reductions in our margins. We expect that occasional component shortages and delays in deliveries of some components will continue to occur. If we are unable to procure sufficient quantity components in a timely fashion, we may experience production delays, which could harm our relationships with current or prospective customers and reduce our sales.

The principal raw materials used by the Company are large scale integrated, or LSI, circuits, digital signal processors, or DSP, LCD driver IC semiconductors, FPC boards, LCD panels, TFT panels and batteries. At times, the pricing and availability of these raw materials can be volatile, attributable to numerous factors beyond the Company s control, including general economic conditions, currency exchange rates, industry cycles, production levels or a supplier s tight supply. In the past, we have asked our customers to share the increased costs of raw materials where such increased costs would adversely affect the Company s business, results of operations and financial condition. Our customers have generally agreed when so requested in the past. We cannot provide assurances, however, that our customers will agree to share costs in the future and that our business, results of operations and financial condition would not be adversely affected by increased volatility in the price or availability of raw materials.

Production Scheduling

The typical cycle for a product to be designed, manufactured and sold to an OEM customer is one to two years, which includes the production period, the development period and the period for market research and data collection (which is undertaken primarily by our OEM customers). Initially, an OEM customer gathers data from its sales personnel on products for which there is market interest, including features and unit costs. The OEM customer then contacts us, and possibly other prospective manufacturers, with forecasted total production quantities and design specifications or renderings. From that information, we in turn contact our suppliers and determine estimated component and material costs. We later advise our OEM customer of the development costs, charges (including molds, tooling and software design, if applicable) and unit cost based on the forecasted production quantities desired during the expected production cycle.

Once we have agreed with the OEM customer on the quotation for the development costs and the unit cost, we begin the product development if we are engaged to do so. This development period typically lasts less than six months, but may be longer if software design is included. During this time, we complete all molds, tooling and software required to manufacture the product with the development costs generally borne by our customer. Upon completion of the molds, tooling and software, we produce samples of the product for the customer s quality testing, and, once approved, commence mass production of the product. We recover the development costs in relation to molds, tooling and software from our customers.

The production period usually lasts approximately six to twelve months. In some cases, our OEM customer handles all product design and development and engages us only at the point of initial production. Typically, more advanced products have shorter production runs. If total production quantities change, the OEM customer often provides only limited notice before discontinuing orders for a product. At any point in time we may be in different stages of the development and production periods for the various models under development or in production for our OEM customers.

Generally, our production is based on purchase orders received from OEM customers. Purchase orders are often supported by letters of credit or written confirmation from the OEM customer and generally may not be cancelled once confirmed without the mutual consent of the parties. Even in those cases where customers are contractually obligated to purchase products from us or repurchase unused inventory from us, we may elect not to enforce our contractual rights immediately because of the long-term nature of our customer relationships and for other business reasons, and instead may negotiate accommodations with customers regarding particular situations.

In general, we plan for and purchase the materials and components that we will need to manufacture customers products when we receive the purchase order and specifications from the customer. We are assisted in this process by our ERP software system which several of our manufacturing subsidiaries began installing during 2008 and 2009. Installation of our subsidiaries ERP software system was completed in the first half of 2009. The ERP software system includes related integrated applications for managing worldwide procurement and logistics business processes, customer relationships, product life-cycle and supplier relationships and helps us and our customers assure that the materials and components needed to manufacture our customers products arrive at our manufacturing facilities on time to meet production and product delivery schedules. Since our customers are involved in the procurement and delivery of the materials and components we use to manufacture their products, our customers assume the risk of delays or failures of delivery of such materials and components.

We did not suffer a material loss resulting from the cancellation of OEM customer orders for the years ended December 31, 2009, 2010 or 2011.

Sales and Marketing

We focus on developing close relationships with our customers at the development and design phases and throughout all stages of production. We identify, develop and market new products and technologies that benefit our customers and position us as a strong EMS provider with the ability to design and develop products.

Sales and marketing operations are integrated processes involving direct salespersons, project managers and senior executives. We direct our sales resources and activities at several management and staff levels within our customers and prospective customers. We receive unsolicited inquiries resulting from word of mouth, from public relations activities, and through referrals from current customers. We evaluate these opportunities against our customer selection criteria and evaluation procedure. Upon approval, we assign a salesperson to the customer.

Seasonality

Historically, our sales and operating results have often been affected by seasonality. Sales of products and components related to mobile phones have generally been lower in the first quarter after peaking in the fourth quarter. Sales of educational products and home entertainment devices are often higher during the second and third quarters in anticipation of the start of the school year and the holiday season. Similarly, consumer electronics products have historically been lower in the first quarter resulting from both the closing of our factories in China for the Lunar New Year holidays and the general reduction in sales following the holiday season.

The long, national seasonal breaks in the PRC, such as the Chinese Lunar New Year holidays occurring in the first quarter and the National Day Golden week occurring in the fourth quarter, typically adversely affects our ability to manufacture products, obtain components and materials from suppliers and receive and process orders from customers and accordingly our results of operations during these period can be expected to suffer.

Transportation

Transportation of components and finished products to and from Shenzhen is by truck. Component parts purchased from Japan, Korea, Singapore and elsewhere of the world are generally shipped by air and delivered to our designated forwarders warehouse located in Hong Kong. To date, we have not been materially impacted by any transportation problems. However, transportation difficulties affecting air cargo or shipping, such as an extended closure of ports that materially disrupt the flow of our customers products into the United States, could significantly and adversely influence our sales and margins if, as a result, our customers delay or cancel orders or seek concessions to offset expediting charges they incur pending resolution of the problems causing the port closures.

Competition

The electronic manufacturing services we provide are available from many independent sources as well as from our current and potential customers with internal manufacturing capabilities. The following table identifies those companies who we believe are our principal competitors (listed alphabetically) by category of products or services we provide.

Product/Service	Competitor
EMS	Celestica, Inc. Flextronics International Ltd. Hon Hai Precision Industry Co., Ltd. Jabil Circuit, Inc. Sanmina-SCI Corporation
Image capturing devices and their modules	Altus Technology Inc. (controlled by Foxconn) Lite-on Technology Corporation Logitech International S.A. The Primax Group
Mobile phone accessories	Balda-Thong Fook Solutions Sdn., Bhd. Celestica, Inc. Elcoteq Network Corporation Flextronics International Ltd. Foster Corporation Foxlink Group Merry Electronics Co., Ltd. WKK International (Holdings) Ltd.
Liquid crystal display, or LCD panels	Tianma Microelectronics Co., Ltd. Truly International Holdings Ltd. Varitronix International Ltd. Yeebo (International) Holdings Ltd.
Telecommunication subassemblies and components	Flextronics International Ltd. LG. Philips LCD Co., Ltd. Samsung Electronics Varitronix International Ltd.
Consumer electronic products (calculators, personal organizers and linguistic products)	Computime Limited Inventec Co., Ltd. Kinpo Electronics, Inc. VTech Holdings Limited
FPC boards/FPC Subassemblies	Ichia Technologies Inc. Nitto Denko (HK) Ltd. NOK Corporation Sumitomo Chemical Co., Ltd. Fujikura Ltd.

Many of our competitors have greater financial, technical, marketing, manufacturing, regional shipping capabilities and international logistics support and personnel resources than we do. As a result, Nam Tai positions itself as a competitive-priced EMS with niches in key product and technology categories focusing on advanced manufacturing technique and processes as well as design and development capabilities in these niche areas to compete successfully against with these organizations.

In addition to intense competition from large FPC board manufacturers located in Taiwan, China, Korea, Singapore, North America, Japan and Europe, such as those listed in the above table opposite FPC boards/FPC subassemblies , we also face such competition from large, established EMS providers that have acquired or, like we have, developed their own FPC manufacturing capabilities, and have extensive experience in electronics assembly. Furthermore, many companies in our target customer base are moving the design and manufacturing of their products to original engineering manufacturers, or OEMs, in Asia. These changes could create pressure on us to provide discounts or lower prices to gain or

maintain market share, which could adversely affect our margins and the profitability of our FPC business and our operating results as a whole.

In addition, if we are unable to capture significant original design manufactures (ODMs) as customers, we may be unable to sustain or grow our FPC business.

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Research and Development

We invest in research and development for developing products, manufacturing and assembly technology that provide us with the potential to offer better and more technologically advanced services to our OEM customers or assist us in working with our OEM customers and in the design and development of future products. We plan to continue acquiring advanced design equipment and to enhance our technological expertise through continued training of our engineers and further hiring of qualified system engineers. These investments are intended to improve the speed, efficiency, costs and quality of our assembly processes.

Additionally, we are responsible for the design and development of new products specified by our customers. We sell these products to OEM customers to be marketed to end users under the customers brand names. To date, we have successfully developed LCD modules, CMOS sensor camera modules, mobile phone accessories and game peripherals for our customers.

Patents, Licenses and Trademarks

We do not have any patents, licenses or trademarks on which our business is substantially dependent. Instead, we rely on our industry expertise, knowledge of niche products and technology and strong long-term relationships with our customers and suppliers.

Property, Plant and Equipment

Our registered office in the British Virgin Islands is located at McNamara Chambers, P.O. Box 3342, Road Town, Tortola. Corporate administrative matters in the British Virgin Islands are conducted at this office through our registered agent, McNamara Corporate Services Limited.

The table below lists the locations, square footage, principal use and the expiration dates of leases or land use rights on the facilities used in our principal operations as of December 31, 2011:

Location	Approximate Square Footage	Principal or Presently Contemplated Use	Owned(1) or lease expiration date
Principal Facilities			
Hong Kong	2,200	Administration	Owned
Shenzhen, China	557,835	Principal manufacturing facilities	2043/2049 (2)
	87,460	Administration	2043/2049 (2)
	350,585	Dormitories	2043/2049 (2)
	41,530	Cafeteria	2043
	33,825	Recreational	2049
Other existing facilities			
Shenzhen, China	134,549	Manufacturing LCD panels and modules	2014 (3)
Wuxi, Jiangsu Province, China	470,360	FPC boards and FPC subassemblies, LCD modules and other products	2056 (4)
Other property			
Guangming, Shenzhen, China	1,270,160	LCD modules and other products	2057 (5)

(1) Only the PRC government and peasant collectives may own land in China. Our principal manufacturing facilities are located on land in which we have entered into a land lease agreement with the PRC government that gives us the right to use the land for 50 years. Similarly, the lands which we have acquired in Wuxi and Guangming Shenzhen will be by 50-year land leases. Our understanding of the practice as it exists today; at the expiration of the land lease, we may be given the right to renew the lease. For our other facilities, we have entered into factory building lease agreements with peasant collectives or other companies for 10 years or less.
(2) Our principal manufacturing facilities occupy two parcels of land with 50-year land leases that we acquired in 1993 and 1999, respectively.
(3) Cancelable upon three months notice.
(4) Construction was completed in 2009 and mass production at this factory began in 2010.
(5) Raw land.

Hong Kong

In October 2005, Nam Tai restructured its subsidiaries to focus its operations in China. We now only maintain a minimal workforce in Hong Kong.

In February 2011, the Company purchased a commercial property having approximately 2,200 square feet at Unit 1201, 12th Floor, Tower 1, Lippo Centre, 89 Queensway, Admiralty, Hong Kong. These premises are located at the Eastern extension of the Hong Kong s Central Business District. The purchase price for the property was approximately $4.6 million, which the Company paid in cash. The Company relocated its Hong Kong office to this location at the end of March 2011.

Shenzhen, China

Principal Manufacturing Facilities

Our principal manufacturing facilities are located in Baoan County, Shenzhen, China. In December 1993, we acquired a 50-year lease for the land on which these facilities are located and initially built a manufacturing facility consisting of approximately 160,000 square feet of manufacturing space, 39,000 square feet of office space, 212,000 square feet of dormitories and 26,000 square feet of full service cafeteria, recreation facilities and a swimming pool. Over the years beginning in November 2000, we have made several additions to these facilities, including:

- a five-story factory with approximately 138,000 square feet of production facilities, including one floor for assembling, one floor of office space, one floor for warehouse use and two floors of class thousand clean room facilities, totaling approximately 626,000 square feet of manufacturing space, when construction was completed in October 2002;

- an additional factory, consisting of approximately 265,000 square feet of space, completing construction in December 2004 on vacant land of approximately 280,000 square feet (approximately 6.5 acres) bordering on our existing facilities that we purchased in July 1999; and

- two additional blocks of dormitories, which we completed during 2005.

With these additions, our principal manufacturing facilities in Shenzhen total approximately 557,835 square feet of manufacturing space, 87,460 square feet of offices, 350,585 square feet of dormitories and 41,530 square feet of cafeteria space, and include a full services recreational building of 33,825 square feet.

LCD Factory

Our LCD manufacturing facility is located in Guanlan, Shenzhen, China and consists of 134,549 square feet of manufacturing space. Our subsidiary, Zastron Shenzhen leases this facility from a third party to manufacture LCDs and LCD Modules. Rent for this facility is approximately $0.02 million a month.

Wuxi, China

We began construction of our new Wuxi manufacturing facility in January 2008 on approximately 470,000 square feet of land we acquired in December 2006. We completed construction in 2009 and by the end of 2009 we had installed machinery and equipment to manufacture FPC boards and FPC subassemblies, providing approximately 150,700 square feet of space to manufacture FPC Boards and FPC subassemblies. The Wuxi factory is first earmarked to manufacture FPC boards, followed by FPC subassemblies and then other electronic products assemblies such as LCD modules. We began manufacturing operations at this factory in 2010.

When we acquired the land use rights in Wuxi, we also acquired similar rights to a second parcel of approximately 515,000 square feet of raw land situated approximately three miles from the first parcel we used for our manufacturing facility. In September 2010, we sold the second Wuxi parcel back to the Wuxi local government for approximately $1.6 million, realizing a gain of approximately $0.8 million on the second parcel.

Planned and Future Expansion

Currently, we have two separate projects planned for expansion, both of which are dependent upon the prompt action and cooperation of local PRC governments.

The first project is the development of the Company s raw land in Guangming Hi-Tech Industrial Park, Shenzhen, PRC, approximately 30 minutes from its existing facilities in Gushu, Shenzhen and approximately one hour driving distance from Hong Kong. We acquired the land use rights to approximately 1.3 million square feet of land in 2005. We plan to develop this land into new manufacturing and support facilities to supplement our manufacturing capabilities in Shenzhen. We believe that immediate expansion of our manufacturing facilities in Shenzhen is needed because we expect that the production capacity at our principal manufacturing facility in Shenzhen to be fully utilized by the end of 2012.

Although we fully paid for the land use rights to our Guangming property in 2007, the local government has delayed the release of this land to us and, to date, we have been unable to commence development of the property. The local government has indicated that the delivery of this land would be further delayed to allow more time to resolve the dispute with the local farmers who originally owned the land.

Our second Wuxi phase II expansion project involves our acquisition of the land use rights to approximately 500,000 square feet of raw land adjacent to our manufacturing facility in Wuxi. On the land adjacent to our facility in Wuxi, we plan to construct buildings that will support our operations such as a manufacturing plant, a canteen, a labor activity center, a research laboratory and testing and training centers. The land was split into 2 portions for acquisition as required by the Government. On February 22, 2012, Wuxi Zastron-Flex entered into a Contract of Land Use Right Acquisition with the Government for the first portion of the land of approximately 159,890 square feet for consideration of approximately $1.6 million (RMB 10.0 million). The second portion of the land is expected to be acquired in the second quarter of 2012.

We currently expect to fund our planned and future expansion by using cash on hand and the excess cash generated from operations after reserving funds to maintain and replace machinery and equipment used at our existing facilities and for working capital. For information regarding our capital expenditures planned for 2012, please see ITEM 4. Information on the Company Capital Expenditures on page 25 of this Report.

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ITEM 4A. UNRESOLVED STAFF COMMENTS
We do not have any unresolved Staff comments.

ITEM 5. OPERATING AND FINANCIAL REVIEW AND PROSPECTS
Except for statements of historical facts, this section contains forward-looking statements involving risks and uncertainties particularly statements found under the heading entitled Trend Information . You can identify these forward-looking statements by words such as expect , anticipate , believe , plans , seek , estimate , intends , should , or may . Forward-looking statements are not guarantees of our future perfo results and our actual results could differ materially from those anticipated in these forward-looking statements as a result of certain factors, including those discussed in Regarding Use of Forward Looking Statements under the section of this Report entitled ITEM 3. Key Information Risk Factors. This section should be read in conjunction with our consolidated financial statements included as ITEM 18. Financial Statements in this Report.

Operating Results

Overview

We are an electronics manufacturing and design services provider to a select group of the world s leading telecommunications and consumer electronic products OEMs. Through our EMS operations, we manufacture electronic components and subassemblies, including FPC boards, FPC board subassemblies, LCD panels, LCD modules, TFT display modules, RF modules, DAB modules, internet radio subassemblies, CMOS imaging sensor modules and PCB subassemblies. These components, modules and subassemblies are used in numerous electronic products, including mobile phones, IP phones, notebook computers, digital cameras, electronic toys and handheld video game and learning devices. We also manufacture finished products, including entertainment devices, mobile phone accessories and educational products.

We assist our OEM customers in the design and development of their products and furnish full turnkey manufacturing services that utilize advanced manufacturing processes and production technologies. Our services include software development services, firmware, and mechanical design, parts and components source and purchasing, product industrialization, and assembly into finished products, or electronic subassemblies with full quality testing and assurance. These services are value-added and assist us in obtaining new business but do not represent a material component of our revenue. We also provide early supplier involvement in design services to develop proprietary products specified by our OEM customers using their brand name.

Net Sales and Cost of Sales

We derive our net sales principally from manufacturing services that we provide to OEMs of telecommunications and consumer electronic products. The market for the products we manufacture is generally characterized by declining unit prices and short product life cycles. Sales to our OEM customers are primarily based on purchase orders we receive from time to time rather than firm, long-term purchase commitments from our customers. We recognize sales, net of product returns and warranty costs, typically at the time of product shipment or, in some cases, as services are rendered.

Our production is typically based on purchase orders received from OEM customers. However, for certain customers, we will occasionally purchase raw materials based on such customers rolling forecasts. Purchase orders are often supported by letters of credit or written confirmation from our OEM customers. We generally do not obtain firm, long-term commitments from our customers. Uncertain economic conditions and our general lack of long-term purchase commitments with our customers make it difficult for us to predict our revenues accurately over the longer term. Even in those cases where customers are contractually obligated to purchase products from us or to repurchase unused inventory from us, we may elect not to immediately enforce our contractual rights because of the long-term nature of our customer relationships and for other business reasons, and instead may negotiate accommodations with customers regarding particular situations.

Gross Margins

It has been the Company s strategy to focus on our key components subassembly business. These complex products generally have relatively high material costs and higher fixed overhead costs as a percentage of total unit costs. Due to our shift in focus in 2011 to the components subassembly business and the higher material and overhead costs of these products our gross margins were adversely affected during 2011. Additionally, our newly operational FPC manufacturing and assembly facility in Wuxi is still operating at a loss, which also adversely affects our gross margin in 2011.

During the three years ended December 31, 2011, we streamlined our product mix and decreased the production of box-built products with higher gross margins, such as Bluetooth headsets and calculators. Consistent with our long-term business strategy, the Company is narrowing its focus to higher-growth, lower-margin business opportunities, such as key component assembly for telecommunication products such as LCD modules and FPC, which leverage the Company s core strengths.

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Gross margins were decreased due to the salaries of our employees increasing substantially in 2011. At December 31, 2011, the average wage level of our direct labor workforce was approximately 27% higher than that at December 31, 2010.

Impact of Foreign Currency Fluctuations

We sell most of our products in U.S. dollars and pay our expenses in U.S. dollars, Japanese yen, Hong Kong dollars and RMB. Between 1994 and July 2005, the market and official RMB rates were unified and the value of the RMB was essentially pegged to the U.S. dollar and was relatively stable. On July 21, 2005, the People s Bank of China adjusted the exchange rate of the 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, at 1:8.11, resulting in an approximate 1.9% appreciation in the value of the RMB against the U.S. dollars from July 2005 to the end of 2005. The following chart illustrates the fluctuations since the July 31, 2005 adjustment of the RMB to the U.S. dollar by showing the exchange ratio at the end of each year from December 31, 2005 to December 31, 2011.

(1) RMB to U.S. dollar data presented in this chart were derived from the historical currency converter available at http://forex-history.net.
(2) If the end of a year fell on a Saturday or Sunday, exchange rate information is provided as of the previous Friday.

The appreciation and depreciation of the RMB compared to the U.S. dollar increases and decreases our costs and expenses to the extent paid in RMB, respectively. Approximately 18%, 17% and 19% of our total costs and expenses and 9%, 7% and 9% of our material costs were in RMB during the years ended December 31, 2009, 2010 and 2011, respectively.

The following table shows the percentage fluctuation in the exchange rate of the RMB to the U.S. dollar during each of the past three years ending December 31:

RMB Exchange Rate to US$1.00 at December 31[1]					
2009		**2010**		**2011**	
Exchange Rate to US$1.00	**Percent change[2]**	**Exchange Rate to US$1.00**	**Percent change[2]**	**Exchange Rate to US$1.00**	**Percent change[2]**
6.827	-0.06%	6.602	3.30%	6.306	4.48%

(1) RMB to U.S. dollar data presented in this table were derived from the historical currency converter available at http://forex-history.net.
(2) From exchange rate at preceding December 31.

In mid-2008, the Chinese government halted the appreciation of the RMB against the U.S. dollar as it did prior to July 21, 2005 because of concerns that a stronger RMB made Chinese exports less competitive during a global recession.

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Accordingly, as shown in the above table, there was virtually no change in the exchange ratio of the RMB to the U.S. dollar during 2009. However, on June 19, 2010 China s central bank announced that it planned to introduce more flexibility in the management of its currency and since then the RMB has again begun to appreciate against the U.S. dollar, increasing approximately 3.30% and 4.48% during 2010 and 2011, respectively.

Similarly, the appreciation and depreciation of the Japanese yen as compared to the U.S. dollar increases and decreases our costs and expenses to the extent paid in yen, respectively. Approximately 18%, 24% and 5% of our total costs and expenses and 14%, 29% and 6% of our material costs were in Japanese yen during the years ended December 31, 2009, 2010 and 2011, respectively. However, we make substantial sales denominated in Japanese yen, which mitigates the effects of fluctuations in the yen-U.S. dollar exchange ratio on our financial results. Approximately 12%, 23% and 5% respectively, of our total net sales were made in Japanese yen during the years ended December 31, 2009, 2010 and 2011, respectively.

The following table shows the percentage fluctuation in the exchange rate of the Japanese yen to the U.S. dollar during each of the past three years ended December 31:

Yen Exchange Rate to US$1.00 at December 31[1]					
2009		2010		2011	
Exchange Rate to US$1.00	Percent change[2]	Exchange Rate to US$1.00	Percent change[2]	Exchange Rate to US$1.00	Percent change[2]
92.434	-1.98%	81.313	12.03%	77.440	4.76%

1) Yen to U.S. dollar data presented in this table were derived from the historical currency converter available at http://forex-history.net.
2) From exchange rate at preceding December 31.

Fluctuations in the exchange rate of the Japanese yen to the U.S. dollar affect our gross margins and financial results, but the effect is mitigated by our yen denominated sales. For example, at December 31, 2010, the yen to U.S. dollar exchange rate appreciated by 12.03% compared to the rate at December 31, 2009. At December 31, 2011, the yen to U.S. dollar exchange rate appreciated by 4.76% compared to the rate at December 31, 2010. These fluctuations resulted in an increase in our material costs and other costs and expenses paid in yen during 2010 and 2011. However, the fluctuations did not have a material net impact on our financial results for either 2010 or 2011, because the material appreciation in the exchange rate was effectively nullified by our yen denominated sales, which nearly matched our costs and expenses paid in yen.

Income Taxes

Under current BVI law, our income is not subject to taxation. Subsidiaries operating in Hong Kong and China are subject to income taxes as described below.

Under current Cayman Islands law, NTEEP is not subject to any profit tax in the Cayman Islands because it has no business operations in the Cayman Islands. However, it may be subject to Hong Kong income taxes as described below since it is registered in Hong Kong.

Our subsidiaries operating in Hong Kong are subject to an income tax rate of 16.5% for the years ended 2009, 2010 and 2011. We calculate income tax provision by applying the income tax rate to our estimated taxable income earned in or derived from Hong Kong during the applicable period.

Efforts by the Chinese government to increase tax revenues could result in decisions or interpretations of the tax laws by the China s tax authorities that are unfavorable to us and which increase our future tax liabilities, or deny us expected refunds. Changes in PRC tax laws or their interpretation or application may subject us to additional PRC taxation in the future. For example, following the implementation of the EIT 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. During the transitional period, the new enterprise income tax rates were/are:

Tax Year	Rate under EIT for enterprises previously subject to 15% tax rate	Rate under EIT for enterprises previously subject to 24% tax rate
2008	18%	25%
2009	20%	25%
2010	22%	25%
2011	24%	25%
2012	25%	25%

Our effective tax rates were 172%, 26% and 51% for each of the three years ended December 31, 2009, 2010 and 2011 respectively. The significant factors that caused our effective tax rates to differ from the applicable statutory rates were as follows:

	$000,000	$000,000	$000,000
	Year Ended December 31,		
	2009	2010	2011
Applicable statutory tax rates	20%	22%	24%
Effect of difference between Hong Kong and PRC tax rates applied to Hong Kong income	65	1	21
Effect of change in tax law	(49)	(1)	(15)
Effect of tax exemption			147
Change in valuation allowance	(37)	(4)	41
Deferred tax liability on withholding tax on undistributed profits of PRC subsidiaries	49	2	
Effect of loss/income for which no income tax benefit/expense is receivable/payable	102	4	(99)
Under (over) provision of income tax expense in prior years	6		(132)
Other items	16	2	64
Effective tax rates	172%	26%	51%

Critical Accounting Policies and Estimates

The preparation of our consolidated financial statements and related disclosures in conformity with accounting principles generally accepted in the United States requires management to make estimates and judgments that affect our reported amounts of assets and liabilities, revenues and expenses, and related disclosures of contingent assets and liabilities. On an on-going basis, we evaluate our estimates and assumptions based upon historical experience and various other factors and circumstances. Management believes that our estimates and assumptions are reasonable under the circumstances; however, actual results may vary from these estimates and assumptions under different future circumstances. We have identified the following critical accounting policies that affect the more significant judgments and estimates used in the preparation of our consolidated financial statements.

For more information on our significant accounting policies, refer to Note 2 Summary of Significant Accounting Policies of our consolidated financial statements.

Allowance for Doubtful Accounts

Our accounts and notes receivable balance is recorded net of allowances for amounts not expected to be collected from customers. Because the Company s accounts and notes receivable are typically unsecured, the Company periodically evaluates the collectability of accounts based on a combination of factors, including a particular customer s ability to pay as well as the age of the receivables. To evaluate a specific customer s ability to pay, the Company analyzes financial statements, payment history, third-party credit analysis reports and various information or disclosures by the customer or other publicly available information. In cases where the evidence suggests a customer may not be able to satisfy its obligation to the Company, we create a specific allowance that is determined to be appropriate for the perceived risk. If the financial condition of a customer deteriorates, resulting in an impairment of their ability to make payments, additional allowances may be required.

There have been no significant changes in our collection rates for our accounts and notes receivable at December 31, 2011 as compared to December 31, 2010.

Impairment of Long-lived Assets and Goodwill

Long-lived assets. The Company reviews the carrying value of its long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying value may not be recoverable.

The Company assesses the recoverability of the carrying value of long-lived assets by first grouping its long-lived assets with other assets and liabilities at the lowest level for which identifiable cash flows are largely independent of the cash flows of other assets and liabilities (the asset

group). Next, the Company estimates the undiscounted future cash flows that are directly associated with and expected to arise from the use of and eventual disposition of such asset group. The Company estimates the undiscounted cash flows over the remaining useful life of the primary asset within the asset group. If the carrying value of the asset group exceeds the estimated undiscounted cash flows, the Company records an impairment charge to the extent the carrying value of the long-lived asset exceeds its fair value. The Company determines fair value through quoted market prices in active markets or, if quotations of market prices are unavailable, through the performance of internal analysis using a discounted cash flow methodology or obtains external appraisals from independent valuation firms. The undiscounted and discounted cash flow analyses all based on a number of estimates and assumptions, including the expected period over which the asset will be utilized, projected future operating results of the asset group, discount rate and long-term growth rate.

In light of the sustained level of the Company s stock price during 2009 and our resulting market capitalization throughout 2009 at a level below our recorded book value at December 31, 2009, the Company conducted a review of Nam Tai s long-lived assets for potential impairment.

In 2010, although the Company s stock price remained below the aggregate book value of its assets, the continuous improvement of the Company s results closed the gap on the difference. Management assessed and determined that there were no events or changes in circumstances to indicate that the carrying amounts of long-lived assets in Nam Tai s Shenzhen facilities were not recoverable and there were no impairment tests conducted with respect to those assets. In view of the continuous operating losses and negative cash flows in Nam Tai s Wuxi facilities, the Company assessed the impairment of its long-lived assets used in the Wuxi facilities, by comparing the undiscounted cash flows with the carrying amounts of the assets. The results indicated that the carrying amounts of the Company s long-lived assets at December 31, 2010 were less than the undiscounted cash flows.

In 2011, although the Company s stock price remained below the aggregate book value of its assets, the continuous improvement of the Company s results closed the gap on the difference. Management assessed and determined that there were no events or changes in circumstances to indicate that the carrying amounts of long-lived assets in Nam Tai s Shenzhen facilities were not recoverable and there were no impairment tests conducted with respect to those assets. In view of the continuous operating losses and negative cash flows in Nam Tai s Wuxi facilities, the Company assessed the impairment of its long-lived assets used in the Wuxi facilities, by comparing the undiscounted cash flows with the carrying amounts of the assets. The results indicated that the carrying amounts of the Company s long-lived assets at December 31, 2010 were less than the undiscounted cash flows.

From the forgoing, the Company concluded that the carrying amounts of Nam Tai s long-lived assets were not impaired at December 31, 2009, 2010 and 2011.

Goodwill. To assess goodwill for impairment, the Company performs an assessment of the carrying value of its reporting units at least on an annual basis or when events and changes in circumstances occur that would more likely than not reduce the fair value of the Company s reporting units below their carrying value. If the carrying value of a reporting unit exceeds its fair value, the Company would perform the second step in its assessment process and would recognize an impairment loss to earnings to the extent the carrying amount of the reporting unit s goodwill exceeds its implied fair value. The Company estimates the fair value of its reporting units using a discounted cash flow methodology. This valuation technique is based on a number of estimates and assumptions, including the projected future operating results of the reporting unit, discount rate, long-term growth rate and appropriate market comparables.

In performing the annual assessment of goodwill for impairment for the years ended December 31, 2009, 2010 and 2011, the Company determined that there was no impairment loss on goodwill 2009 and 2010. We recognized an impairment loss of $3.0 million in 2011, primarily as result of the onset of and impact from future cessation of business of the CECP segment.

The Company s assessments of impairment of long-lived assets, and its periodic review of the remaining useful lives of its long-lived assets are an integral part of the Company s ongoing strategic review of its business and operations. Therefore, future changes in the Company s strategy and other changes (including the discount rate and expected long-term growth rate) in the operations of the Company could impact the projected future operating results that are inherent in the Company s estimates of fair value, resulting in impairments in the future.

Accruals and Provisions for Loss Contingencies

The Company makes provisions for all loss contingencies when information available prior to the issuance of the consolidated financial statements indicates that it is probable that an asset has been impaired or a liability has been incurred at the date of the consolidated financial statements and the amount of loss can be reasonably estimated.

For provisions or accruals related to litigation, the Company makes provisions based on information from legal counsel and management s best estimation. The Company assesses the potential liability for the significant legal proceedings in accordance with FASB ASC 450 *Contingencies* . FASB ASC 450 requires a liability to be recorded if the contingency loss is probable and the amount of loss can be reasonably estimated. The actual resolution of the contingency may differ from the Company s estimates. If the contingency was settled for an amount greater than the estimate, a future charge to income would result. Likewise, if the contingency was settled for an amount that is less than our estimate, a future credit to income would result.

Workforce Reduction

As a result of the global economic crisis, we suffered serious difficulties in production and business operations during 2009 and reduced the net headcount in our operating subsidiaries by approximately 1,900 from 7,104 at December 31, 2008 to 5,203 at December 31, 2009. The amount of employee severance benefits in 2009 was $5.1 million, of which we paid out $4.1 million, recording these amounts under general and administrative expenses, and accrued $1.0 million for future payments, in our balance sheet at December 31, 2009. In 2010 and 2011, we have incurred employee severance payment of approximately $0.7 million and $3.0 million, respectively. For example, in early December 2011, we

experienced a labor strike of approximately 1,200 employees due to dissatisfaction with the 23% increase in the wage package for 2012. Accordingly, the Company paid out $2.7 million in lay-off costs for employee severance benefits. For a breakdown of these severance expenses by operating segment, For more information, see Note 16 of Notes to our Consolidated Financial Statements.

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Summary of Results

The Company sustained a year-over-year revenue growth of 12.7% for 2011 when compared with 2010. The Company has identified significant revenue growth opportunities assembling telecommunication product LCD modules for Japanese multinational corporations (MNCs) that supply global customers. The Company is well-positioned to benefit from this expected trend in 2011.

The following table sets forth key operating results (in thousands, except per share data) for the years ended December 31, 2009, 2010 and 2011:

	Year Ended December 31,			% increase/(decrease)	
	2009	**2010**	**2011**	**2010 vs 2009**	**2011 vs 2010**
Net sales	$ 408,137	$ 534,420	$ 602,317	30.9%	12.7%
Gross profit	40,320	51,294	28,089	27.2	(45.2)
Income (loss) from operations	388	14,801	(11,451)	3,714.7	(177.4)
Consolidated net (loss) income	(535)	15,006	505	(2,904.9)	(96.6)
Basic earnings per share	$ 0.04	$ 0.33	$ 0.01	725.0	(97.0)
Diluted earnings per share	$ 0.04	$ 0.33	$ 0.01	725.0	(97.0)

Key Performance Indicators

The following tables set forth, for each of the quarters in the two years period ended December 31, 2011, certain of management s key financial performance indicators that management utilizes to assess the Company s operating results. The first table presents the results sequentially by quarter and the second table presents the results in quarterly comparisons by year.

	$000	$000	$000	$000	$000	$000	$000	$000
	2010				**2011**			
Days in:	**Mar. 31**	**Jun. 30**	**Sept. 30**	**Dec. 31**	**Mar. 31**	**Jun. 30**	**Sept. 30**	**Dec. 31**
Sales cycle [1]	15	11	9	9	13	12	9	12
Inventory turnover [2]	18	24	24	22	17	22	18	20
Accounts receivable [3]	58	73	67	51	49	44	41	45
Accounts payable [4]	61	86	82	64	53	54	50	53

	Mar. 31	**Mar. 31**	**Mar. 31**	**Mar. 31**	**Mar. 31**	**Mar. 31**	**Mar. 31**	**Mar. 31**
	March 31		**June 30**		**September 30**		**December 31**	
Days in:	**2010**	**2011**	**2010**	**2011**	**2010**	**2011**	**2010**	**2011**
Sales cycle [1]	15	13	11	12	9	9	9	