CELLSTAR CORP
Form 10-K
September 06, 2005
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

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

For the fiscal year ended November 30, 2004

OR

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

For the transition period from to

Commission File Number

0-22972

CELLSTAR CORPORATION

(Exact name of registrant as specified in its charter)

Delaware **(State or other jurisdiction of incorporation or organization)**	**75-2479727** **(I.R.S. Employer Identification No.)**

1730 Briercroft Court **Carrollton, Texas** **(Address of principal executive offices)**	**75006** **(Zip Code)**

Registrant s telephone

number including area

code: (972) 466-5000

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	**Name of each exchange on which registered**
None	**N/A**

Securities registered pursuant to Section 12(g) of the Act:

Common Stock, par value $0.01 per share

(Title of Class)

Rights to Purchase Series A Preferred Stock

(Title of Class)

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 ¨ No x

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ¨

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes x No ¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act.): Yes ¨ No x

The aggregate market value of the registrant s common stock held by non-affiliates of the registrant as of May 28, 2004, the last business day of the Company s most recently completed second fiscal quarter, based on the closing sale price of $6.07 as reported by the Nasdaq National Market on May 28, 2004, was approximately $80,887,618 (for purposes of determination of the above stated amounts, only directors, executive officers and 10% or greater stockholders have been deemed affiliates).

On August 26, 2005, there were 20,509,529 outstanding shares of common stock, $0.01 par value per share, and the closing sales price was $1.50 as quoted on the Pink Sheets®.

DOCUMENTS INCORPORATED BY REFERENCE

None.

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CELLSTAR CORPORATION

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PART I.

Item 1. Business

CellStar Corporation (the Company or CellStar) is a leading provider of distribution and value-added logistics services to the wireless communications industry, with operations in the North American and Latin American Regions. In August 2005, the Company decided to exit the Asia-Pacific Region. The Company provides comprehensive logistics solutions and facilitates the effective and efficient distribution of handsets, related accessories, and other wireless products from leading manufacturers to network operators, agents, resellers, dealers and retailers. The Company also provides activation services in some of its markets that generate new subscribers for wireless carriers.

The Company s North American Region consists of the United States, excluding the Company s Miami, Florida operations (the U.S.). The Company s Latin American Region consists of Mexico, Chile and the Company s Miami, Florida operations. The Company s Asia-Pacific Region consisted of the People s Republic of China (the PRC), Hong Kong and Taiwan (the Greater China Operations) and the Philippines. The Company s headquarters (Corporate) are located in Carrollton, Texas.

Overview of Significant Developments in 2004

Asia-Pacific Region

Historically, the Asia-Pacific Region had been profitable and contributed significantly to the Company s consolidated results. In prior years, the region represented approximately 50% of the Company s total revenues, and approximately 90% of the revenues in the Asia-Pacific Region have been generated by the operations in the PRC. The Asia-Pacific Region was the Company s largest source of operating income from 1996 2000 and in 2002. In late 2002, the Company believed that the intrinsic value of its Asia-Pacific Region was not fully reflected in the market price of its common stock. As a result, the Company engaged UBS Securities LLC (UBS Securities) to assist it in evaluating transactions that could result in recognizing the value that the Company believed was locked up in the Asia-Pacific Region, which was substantially comprised of its Greater China Operations. Those evaluations focused on a number of possible transactions including a possible initial public offering of all or a portion of the Asia-Pacific Region operations, a spin-off, a sale to outside investors or a management buyout.

In March 2003, the Company filed a preliminary proxy statement with the Securities and Exchange Commission (SEC) that described the proposal to divest up to 70% of the Greater China Operations (the CellStar Asia Transaction), which would have included an initial public offering (IPO) of its Greater China Operations on the Stock Exchange of Hong Kong (SEHK). In May 2003, however, the Company announced the delay of the CellStar Asia Transaction due to the spread of severe acute respiratory syndrome (SARS), which negatively impacted the business environment and financial markets in Hong Kong and China, as well as limited the Company s ability to market the IPO. In early 2004, and based on the advice of UBS Securities, the Company decided to proceed with the IPO targeting a summer 2004 completion date. Accordingly, the Company filed a new preliminary proxy statement with the SEC in March 2004. Due to delays in the process of listing the stock on the SEHK and an unfavorable financial market in Hong Kong, the Company, upon the advice from UBS Securities, announced in May 2004, that the CellStar Asia Transaction would be delayed until the fall of 2004. From the first quarter of 2004 through the third quarter of 2004 revenues in the PRC were declining and accounts receivable trends were negative. As a result, the Company announced in September 2004 that it would not proceed with the CellStar Asia Transaction.

During 2004, the Company experienced a significant increase in the reported accounts receivable days outstanding (DSO s) in its operations in the PRC. Historically, the Company had no significant collection issues in the PRC. During 2004, Asia-Pacific Region and PRC management attributed the increase in DSO s to

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the extension of longer credit terms to the PRC s local distributors (the Small Bees) to encourage them to sell to large-scale retailers and carriers who required longer credit terms from their suppliers and to expand into the tier 3 and tier 4 cities. In October 2004, the Chief Financial Officer of the Asia-Pacific Region resigned and on December 1, 2004, the Company hired a Director of Accounting for the Asia-Pacific Region. During the fourth quarter closing process, concerns over the lack of collection of receivables were being raised by Corporate management and the Director of Accounting for the Asia-Pacific Region. In early February 2005, the Director of Accounting raised certain specific issues regarding some of the PRC s accounts receivable and revenue. The issues primarily focused on three areas: (1) whether or not certain sales to the Small Bees were valid; (2) whether claims made by the Small Bees for credits related to certain sales by the Company to the Small Bees should be recorded as a reduction in revenues; and (3) the accounting for certain trade receivables with informally extended credit terms. The Company delayed the filing of its Annual Report on Form 10-K for the fiscal year ended November 30, 2004, (the Form 10-K) and subsequent Quarterly Reports on Form 10-Q while these issues were reviewed by the Company and the Audit Committee of the Company s Board of Directors. Corporate senior management assisted by the internal auditors performed a review in the PRC of these issues. During the review process, Corporate senior management kept the Audit Committee updated on its findings. In May 2005, Corporate management concluded that prior period financial statements could not be relied upon and should be restated. On August 1, 2005, the Company announced that the Audit Committee of the Company s Board of Directors had finished its independent review of accounts receivable and revenue issues in the Company s Asia-Pacific Region. Independent counsel and independent forensic accountants assisted the Audit Committee in its review. The review by the Audit Committee concluded the following:

- During the second quarter of 2004, the Company s operations in the PRC booked sales of inventory that had not been sold. Certain PRC employees took steps to conceal this fact from the Company s auditors.

- During the 2004 IPO period, the PRC operations may have sold products to its distributors at prices that were higher than market prices and deferred rebates to inflate revenues. Prior practice had been to price products at the then-prevailing market price.

- The Company failed to properly accrue for rebates offered to its distributors in the PRC.

- The Audit Committee agreed with management s conclusion that, since 2000, some sales by the PRC operations were made on extended credit terms with neither written agreements nor terms of payment defined. As a result of this, sales were inappropriately recorded.

- There were weaknesses in internal controls related to corporate governance and oversight and also weaknesses related to revenue recognition, rebate claims, inventory, and accounts receivable in the PRC operations. The Audit Committee has asked that management remediate these weaknesses.

Based upon the Company s review, as well as its evaluation of the Audit Committee s findings, the Company has restated its previously reported financial results for the fiscal years 2000 to 2003 and for the quarters ended February 29, May 31, and August 31, 2004. (See Item 1. Business Asia-Pacific Accounts Receivable and Revenue Issues). All discussion in this Form 10-K refers to the restated amounts unless otherwise noted.

For the year ended November 30, 2004, the Company incurred an operating loss of $76.8 million in the Asia-Pacific Region. This operating loss was primarily a result of changes in the market conditions in the PRC including an oversupply of handsets and significant price reductions, the inability of the Company to obtain the desired product and terms from its traditional primary suppliers, low market acceptance and quality issues with product manufactured by non-traditional suppliers, deteriorating relationships with the Small Bees and increased bad debt expense. Company management has determined that to return the operations in the Asia-Pacific Region to profitability, the Company would have to invest significant amounts of capital, access to which it does not currently have. Additionally, the Company would have to reestablish relationships with the Small Bees or develop a new distribution network, find a new management team, and fill numerous personnel openings. The Company also believes that the cost of revising, implementing, monitoring and maintaining improved

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internal controls for these operations will be cost-prohibitive given the difficulties caused by the geographic distance from Corporate, language and cultural differences, low margins and the highly competitive nature of the market. In addition, the Company expects competition to increase in the future due to the easing of restrictions on foreign entities engaging in wholesale distribution in China.

The Company decided to exit the Asia-Pacific Region and on September 2, 2005, the Company sold its PRC and Hong Kong operations (the CellStar Asia Sale) to Fine Day Holdings Limited, a company formed by Mr. A.S. Horng, who was the Chairman and Chief Executive Officer of CellStar (Asia) Corporation Limited and effectively the head of the Company s Asia-Pacific Region, for a total consideration of $12 million, consisting of $6 million in cash paid at closing and a $6 million subordinated promissory note maturing September 1, 2008. In connection with the CellStar Asia Sale, effective September 2, 2005 Mr. Horng resigned as an executive officer of the Company and agreed to terminate his employment agreement. In approving the sale to Fine Day Holdings Limited, the Board of Directors had meetings with Company management and various advisors regarding the transaction and obtained a fairness opinion.

The Company believes the issues in the PRC and the related delay in filing the financial statements have had a dramatic impact on the Company. The Company has experienced a tightening of credit by its vendors, including the Company s primary supplier Motorola, Inc. (Motorola). This has impacted the Company s cash flow, and currently the Company has more orders in the North American Region than credit capacity. Concerns over the viability of the Company have made securing new customers more difficult and has required management to address this concern with existing customers. Employee turnover has increased and employee morale has suffered. Significant time and effort has gone into resolving the issues in the PRC and has strained the Company s management and financial resources. In addition, the Company has incurred significant professional fees.

Due to the Company s inability to timely file its Form 10-K for fiscal 2004 and Form 10-Q for the first quarter of 2005, the Company s common stock was delisted from the Nasdaq National Market effective with the open of business on June 10, 2005. As a result of the delisting, the Company s common stock is currently traded on the over-the-counter market, and is quoted in the Pink Sheets®, which provides electronic quotation information.

In June 2005, the Company announced it had retained the services of Raymond James & Associates, Inc. to act as its investment banking advisor to assist the Company with the evaluation of its financial and strategic alternatives.

Management Changes

In April 2004, the Company announced that effective April 30, 2004, James L. Johnson would step down as Chairman of the Board. The Company also announced that Terry S. Parker would assume Mr. Johnson s position as Executive Chairman, and Robert A. Kaiser, the Company s President and Chief Operating Officer, would become Chief Executive Officer. As Executive Chairman, Mr. Parker retained responsibility for the Company s Asia-Pacific operations. In May 2004, the Company announced the resignation of Paul C. Samek as Chief Financial Officer, and that it had promoted Raymond L. Durham to the position of Senior Vice President and Chief Financial Officer from his former position of Vice President and Corporate Controller. Juan Martinez Jr. assumed the role of Vice President Corporate Controller in June 2004, and the Board of Directors designated him as principal accounting officer on December 16, 2004.

On November 9, 2004, the Company announced that Mr. Zhang Yue had been named Senior Vice President of the Asia-Pacific operations and President of the PRC operations.

On January 18, 2005, the Company announced the appointment of Dr. Da Hsuan Feng as a Class II Director, with a term expiring in 2006, filling the vacancy created by Mr. Johnson s death in November 2004.

On May 2, 2005, the Company announced the resignation of Terry S. Parker as Executive Chairman and a member of the Board of CellStar Corporation. The Company also announced that Robert A. Kaiser was named a

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director and Chairman of the Board of CellStar Corporation. The Company announced the appointment of Mr. Parker as Chairman of the Board of Directors for CellStar International Corporation/Asia (the Asia Board), a Delaware subsidiary which acts as the U.S. holding company for the Asia-Pacific Region, and the appointment of additional directors on the Asia Board. The Asia Board reports directly to Robert Kaiser. Mr. Kaiser assumed, for the first time, responsibility for the Asia-Pacific Region. The Company also announced that James Chan was named Chief Financial Officer of the Asia-Pacific Region.

On May 31, 2005, the Company announced that Mr. John T. Kamm resigned from the Company s Board of Directors. Mr. Kamm was named as a Class III Director in December 2003.

On July 20, 2005, the Company announced that effective July 14, 2005, the Company had terminated the employment of Mr. Terry S. Parker.

On July 25, 2005, the Company announced that effective July 21, 2005, the Company had terminated the employment of Mr. Lawrence P. King. Mr. King was serving as President and Chief Operating Officer of the Asia-Pacific Region.

Other

In 2004, the Company sold or closed three of its operations that did not present significant growth opportunities. The Company completed the divestiture of its operations in Colombia and Singapore and has substantially closed its operations in The Philippines. See Management s Discussion and Analysis of Financial Condition and Results of Operations International Operations.

On June 17, 2005, the Company announced a proposal to sell up to $50.0 million of convertible debentures and on June 16, 2005, the Company signed a letter of intent to sell up to $25.0 million of debentures to Stanford Financial Group Company and its affiliates (Stanford). On July 14, 2005, the Company announced Stanford would not proceed with the purchase of up to $25.0 million of debentures.

On August 25, 2005, the Company entered into an agreement to sell its operations in Taiwan to Mrs. L.C. Lin, a Taiwanese individual and a former employee of those operations, for nominal consideration. The sale is expected to close in September 2005.

Our Business

The Company s distribution services include purchasing, selling, warehousing, picking, packing, shipping and just-in-time delivery of wireless handsets and accessories. The Company also offers one of the industry s first completely integrated asset recovery and logistics services, its Omnigistics® (patent pending) supply chain management system. In addition, the Company offers its customers value-added services, including Internet-based supply chain services via its OrderStar® system (patent pending), Internet-based tracking and reporting, inventory management, marketing, prepaid wireless products, product fulfillment, kitting and customized packaging, private labeling, light assembly, accounts receivable management and end-user support services. The Company also provides wireless activation services and operates retail locations in certain markets from which wireless communications products and accessories are marketed to the public.

The Company markets its products to wholesale purchasers using, among other methods, direct sales strategies, the Internet, strategic account management, trade shows and trade journal advertising. The Company offers a variety of name brand products, comprehensive forward and reverse logistics solutions, highly-responsive customer service, merchandising and marketing elements and access to hard-to-find products to potential new and existing customers.

The Company, a Delaware corporation, was formed in 1993 to hold the stock of National Auto Center, Inc. (National Auto Center), a company that is now an operating subsidiary. National Auto Center was originally

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formed in 1981 to distribute and install automotive aftermarket products. In 1984, National Auto Center began offering wireless communications products and services. In 1989, National Auto Center became an authorized distributor of Motorola wireless handsets in certain portions of the United States. National Auto Center entered into similar arrangements with Motorola in the Latin American Region in 1991, and the Company entered into similar arrangements with Motorola in the Asia-Pacific Region in 1994. During fiscal 2004, the Company also maintained similar distributor agreements with other manufacturers, including Nokia Inc. (Nokia), Wuhan NEC Mobile Communication Co., Ltd. (NEC), Kyocera Wireless Corp. (Kyocera), Samsung Telecommunications America, L.P. and Samsung Electronics Latinoamerica Miami, Inc. (Samsung) and Siemens Shanghai Mobile Communications Ltd. (Siemens) .

Wireless communications technology encompasses wireless communications devices such as handsets, personal digital assistants, instant messaging devices and two-way radios. The Company believes that handsets with video capability, polyphonic ring tones and digital camera capabilities should increase consumer demand for new and replacement handsets. In addition, the Company believes that the emergence of new and improving technologies, including portable multi-media devices, should create opportunities in the wireless market as users continually strive to stay connected while remaining mobile.

From its inception in 1983, the wireless handset market grew rapidly until 2001, when overall growth in the industry slowed. In 2002, the Company was faced with a difficult economic environment in the wireless industry in general. During the second and third quarters of 2003, the Company s overall revenues were severely impacted by the spread of SARS in the Asia-Pacific Region. However, demand for wireless products and services began increasing during the fourth quarter of 2003 and remained strong in 2004. According to UBS Investment Research (UBS), at the end of 2004 there were an estimated 1.55 billion wireless subscribers worldwide, an increase of 19.7% from 2003. UBS estimates that approximately 672 million handsets were sold in 2004; an increase of 28.3% over 2003. However, UBS estimates that handset sales will slow in 2005 to an estimated 762 million, an increase of only 13.5% over 2004. Growth is continuing in replacement handset sales as well. In 2004, UBS estimates that 353 million replacement handsets were sold worldwide, an increase of 19.6% over 2003. UBS expects double digit growth in replacement handsets in 2005 and 2006, 32.7% and 22.6%, respectively, even though it expects a slowdown in total handsets sold for those years.

The Company believes that future growth in the worldwide subscriber base, coupled with strong demand for replacement handsets in developed markets, should create significant new opportunities for growth. The Company believes that the convergence of existing and emerging technologies into a single multifunction handset offering increased Internet capability and music and video options should provide ample incentive for wireless users who desire to upgrade their existing handsets. In addition, demands for increasingly complex logistics services should spur growth in the logistics services industry. The Company believes that the wireless communications industry should continue to grow, although at a slower rate than in prior years, for a number of reasons, including strong replacement sales, multi-feature handsets, increased service availability, the lower cost of wireless service compared to conventional landline telephone systems and the availability of handsets with emerging technologies. The Company also believes that advanced digital technologies have led to increases in the number of network carriers, which have promoted greater competition for subscribers and will continue to result in increased demand for wireless communications products. However, the Company faces many challenges, including securing adequate financial resources, the continued consolidation of carriers in the U.S. market and improving operating margins.

Cautionary Statements

The Company s success will depend upon, among other things, its ability to implement its business strategies, to maintain its channels of distribution, continuing to secure an adequate supply of competitive products on a timely basis and on commercially reasonable terms, economic conditions, wireless market conditions, the financial health of its largest customers, its ability to improve its operating margins, service its indebtedness and meet covenant requirements, secure adequate financial resources, continually turn its

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inventories and accounts receivable, successfully manage changes in the size of its operations (including monitoring operations, controlling costs, maintaining adequate information systems and effective inventory and credit controls), manage operations that are geographically dispersed, achieve significant penetration in existing and new geographic markets, hire, train and retain qualified employees who can effectively manage and operate its business, and its ability to respond to further consolidation in the U.S. regional carrier segment. The Company s success will also depend upon its ability to design and maintain policies and procedures which enable the Company to avoid any recurrence of the matters which gave rise to the material weaknesses discussed in Item 9A Controls and Procedures.

The Company s foreign operations are subject to various political and economic risks including, but not limited to, the following: potentially unstable channels of distribution, increased credit risks, political instability, economic instability, currency controls, currency devaluations, exchange rate fluctuations, export control laws that might limit the markets the Company can enter, inflation, changes in laws and enforcement policies related to foreign ownership of businesses abroad, foreign tax laws, trade disputes among nations, changes in cost of and access to capital, changes in import/export regulations, including enforcement policies, gray market resales and tariff and freight rates.

In addition to the factors listed above, threats of terrorist attacks, a decline in consumer confidence and economic weakness in the U.S. and throughout the countries in which the Company does business could have a material adverse impact on the Company.

The Company s consolidated financial statements and accompanying notes, which include certain business segment and geographic information for the last three fiscal years, can be found in Part IV of this Form 10-K.

Asia-Pacific Region

Historically, the Asia-Pacific Region had been profitable and contributed significantly to the Company s consolidated results. In prior years, the region represented approximately 50% of the Company s total revenues and approximately 90% of the revenues in the Asia-Pacific Region have been generated by the operations in the PRC. The Asia-Pacific Region was the Company s largest source of operating income from 1996 2000 and in 2002. In 2004, the Asia-Pacific Region represented approximately 35% of the Company s total revenues or $450.5 million and reported an operating loss of $76.8 million. Operating income (loss) for the region was $3.4 million, $20.2 million, $31.7 million and ($25.5) million for the years 2000 through 2003, respectively.

Because of the success of the Asia-Pacific Region from 1996-2002, in late 2002 the Company believed that the intrinsic value of its Asia-Pacific Region was not fully reflected in the market price of its common stock. As a result, the Company engaged UBS Securities to assist it in evaluating transactions that could result in recognizing the value that the Company believed was locked up in the Asia-Pacific Region, which is substantially comprised of its Greater China Operations. Those evaluations focused on a number of possible transactions including a possible initial public offering of all or a portion of the Asia-Pacific Region operations, a spin-off, a sale to outside investors or a management buyout.

In March 2003, the Company filed a preliminary proxy statement with the SEC that described the CellStar Asia Transaction, which would have included an IPO of the Greater China Operations on the SEHK. In May 2003, the Company announced that it would delay the CellStar Asia Transaction due to the spread of SARS, which negatively impacted the business environment and financial markets in Hong Kong and China, as well as limited the Company s ability to market the IPO. Based on the advice of UBS Securities, the Company decided to proceed with the IPO in early 2004 targeting a summer 2004 completion date. On March 10, 2004, the Company filed a new preliminary proxy statement with the SEC. Due to delays in the process of listing the stock on the SEHK and an unfavorable financial market in Hong Kong, the Company, upon the advice from UBS Securities, announced in May 2004, that the CellStar Asia Transaction would be delayed until the fall of 2004.

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From the first quarter of 2004 through the third quarter of 2004 revenues in the PRC were declining and accounts receivable trends were negative. As a result, the Company announced in September 2004 that it would not proceed with the CellStar Asia Transaction.

Two key factors were critical to the prior success of the PRC operations. First, the relationships that the Asia-Pacific Region management team built with its distribution channel consisting of 73 local distributors in China. Approximately 95% of the total revenues in China have historically been generated by 26 of these distributors, referred to as the Small Bees. The Company has cooperative arrangements with the Small Bees that allow them to establish wholesale and retail operations using CellStar s trademarks. Under the terms of these arrangements, CellStar has historically provided services, sales support, training and access to promotional materials for use in their operations. As a result of these arrangements, approximately 1,700 retail points of sale in the PRC display the CellStar name and trademarks. In addition to these branded retail outlets, an additional 15,000 outlets in China carry CellStar products. The second key factor to the success of the Company s PRC operations was the ability to secure the desired product and terms, including exclusivity of certain models, offered by the operations primary suppliers such as Nokia and Motorola.

As the wireless handset market began to mature, however, there were several key factors that negatively impacted the PRC operations.

Many of the manufacturers began to ship large volumes directly to retailers, in particular large scale superstores and provincial distributors including in some cases the Small Bees. This shift in strategy has moved the manufacturers closer to the end user, thereby reducing the layers of distribution and limiting the use of national distributors such as the Company.

The Company s PRC revenues have historically been from the sale of handsets supplied by Nokia and Motorola. From late 2002 to mid 2003, Nokia and Motorola lost significant market share to the local Chinese manufacturers.

There was an oversupply of handsets.

During the second quarter of 2004, one of the Company s largest suppliers in China lowered its handset prices in an effort to boost its declining market share. Several other suppliers responded by also lowering their prices.

The growth rate of handset sales in major cities has slowed down as penetration rates increased. To boost new growth, carriers began to subsidize handsets. This was a dramatic shift in the role of the carrier in China, as carriers have not historically subsidized handsets.

The Chinese government implemented tighter economic controls to slow down the economy.

The changing wireless handset market, combined with the impact of the Asia-Pacific management team focusing their attention on the IPO in the first half of 2004, ultimately resulted in a dramatic downturn in the Company s business. The manufacturers price reductions, particularly in the first half of 2004, put tremendous pressure on the gross margins of the Company and the Small Bees. In prior years, the Company was able to seek price protection or other forms of compensation from its suppliers that generally allowed the Company to make a sufficient margin. The Small Bees would then similarly seek some form of compensation from the Company. While the Company had no legal obligation to provide compensation to the Small Bees, frequently the Company would grant some form of compensation, usually in the form of discounts on future purchases. The oversupply of product and the downward trend in prices in 2004 increased the amount of claims received by the Company from the Small Bees. Because the Company was not making sufficient margin and the manufacturers could not or would not provide assistance in many cases, the Company could not compensate all of the requests for credits from the Small Bees leading to a deterioration in the business relationships.

In prior years the PRC operations were frequently able to obtain exclusivity on certain models, which allowed the Company to maintain the margins on the product further into the product life cycle. The PRC

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operations were not as successful as in prior years in obtaining the desired product or exclusivity from its primary suppliers. As a result, the Company was not able to fully meet the product needs of the Small Bees and to maintain margins. To broaden its product offerings, the Company purchased product from non-traditional suppliers. While the Company initially had some success with some of these products, it incurred losses on many of these products due to low market acceptance and quality problems as many of these products were ultimately returned to the Company. As the Company increasingly became unable to obtain highly desirable product, the Small Bees had to seek other vendors to supply their product needs. The Small Bees were also still seeking compensation from the Company for their losses through their request for credits. The Small Bees began to delay payments, or not make payments, to the PRC operations on their accounts receivable. The Company believes the slow-down in payments allowed the Small Bees to utilize the capital to purchase products from other sources and to increase their leverage in getting rebates from the Company on their prior purchases. This led to increased working capital shortages which further inhibited the PRC operations ability to obtain product and further reduced the Small Bees incentive to pay the PRC operations.

Additionally, during the first quarter of 2004, there were efforts by the PRC management to aggressively promote sales in the PRC to promote the IPO. During the 2004 IPO period, the PRC operations may have sold products to the Small Bees at prices that were higher than market prices and deferred rebates to inflate revenues. Prior practice had been to price products at the then-prevailing market prices. The Small Bees made numerous claims for rebates, and the deferral and/or denial of rebates further contributed to the deterioration of the relationships with the Small Bees.

As a result, revenues for the PRC declined each quarter during 2004. Gross margins were negative because of the severe downward pressure on pricing, the rebates effectively promised, as well as obsolescence charges primarily associated with the less desirable products from non-traditional suppliers.

The Company also incurred increased bad debt expense. Because of the changes in the market, certain of the Small Bees also had financial and operational difficulties and were not able to pay the Company. The deterioration in the relationships with the Small Bees also resulted in the unwillingness of the Small Bees to pay. The Company believes that efforts to collect through traditional legal means will be difficult due to poor documentation, the high cost of legal action and the difficulty of enforcing judgments, if obtained, against small businesses such as the Small Bees.

The Company s revenues in the PRC have continued to decline in 2005. Because of the losses, the PRC s suppliers have significantly reduced the availability of credit. Due to the lack of credit and capital, the PRC operations have not been able to purchase the necessary inventory, further damaging the relationships with the Small Bees. The Company has determined that to return the operations in the PRC to profitability, the Company would have to invest significant amounts of capital, access to which the Company does not have. In addition, the Company would need to reestablish relationships with the Small Bees or develop a new distribution network, find a new management team, and fill numerous personnel openings. The Company also believes that the cost of revising, implementing, monitoring and maintaining improved internal controls for these operations will be cost-prohibitive given the difficulties caused by the geographic distance from Corporate, language and cultural differences, low margins and the highly competitive nature of the market. Also, the Company expects competition to increase in the future due to the easing of restrictions on foreign entities engaging in wholesale distribution in China. Accordingly, the Company has decided to exit the Asia-Pacific Region and on September 2, 2005, the Company sold its PRC and Hong Kong operations to Fine Day Holdings Limited, a company formed by Mr. A.S. Horng, who was the Chairman and Chief Executive Officer of CellStar (Asia) Corporation Limited and effectively the head of the Company s Asia-Pacific Region for a total consideration of $12 million, consisting of $6 million in cash paid at closing and a $6 million subordinated promissory note maturing September 1, 2008. In connection with the CellStar Asia Sale, effective September 2, 2005, Mr. Horng resigned as an executive officer of the Company and agreed to terminate his employment agreement. The Company will also retain certain claims against vendors. On August 25, 2005, the Company entered into an agreement to sell its operations in Taiwan to Mrs. L.C. Lin, a Tawianese individual and former employee of the

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Taiwan operations, for nominal consideration. The sale is expected to close in September 2005. The Taiwan operation had not been profitable since the fourth quarter of 2002. At November 30, 2004, the Company has reduced the carrying value of these operations to their estimated net realizable value of $21.1 million. The estimated net realizable value at November 30, 2004 includes cash subsequently transferred to Corporate as well as estimated losses of $11.2 million from the operations of PRC, Hong Kong and Taiwan during the period from December 1, 2004 to August 31, 2005. The losses from December 1, 2004 to August 31, 2005 are included in the net realizable value at November 30, 2004, as the operations funded these losses.

Accounts Receivable and Revenue Issues in the Asia-Pacific Region

During 2004, the Company experienced a significant increase in the reported DSO s in its operations in the PRC. Historically, the Company had no significant collection issues in the PRC. During 2004, Asia-Pacific Region and PRC management attributed the increase in DSO s to the extension of longer credit terms to the Small Bees to encourage them to sell to large-scale retailers and carriers who required longer credit terms from their suppliers and to expand into the tier 3 and tier 4 cities.

In October 2004, the Chief Financial Officer of the Asia-Pacific Region resigned, and on December 1, 2004, the Company hired a Director of Accounting for the Asia-Pacific Region. During the fourth quarter closing process, concern over the lack of collection of receivables were being raised by Corporate management and the Director of Accounting for the Asia-Pacific Region. In early February 2005, the Director of Accounting raised certain specific issues regarding some of the PRC s accounts receivable and revenue. The issues primarily focused on three areas: (1) whether or not certain sales to the Small Bees were valid; (2) whether claims made by the Small Bees for credits related to certain sales by the Company to the Small Bees should be recorded as a reduction in revenues; and (3) the accounting for certain trade receivables with informally extended credit terms. As a result, the Company delayed filing its Form 10-K for 2004 and subsequent Quarterly Reports on Form 10-Q while these issues were reviewed by the Company and the Audit Committee. Corporate senior management assisted by the internal auditors performed a review in the PRC of these issues. During the review process, Corporate senior management kept the Audit Committee updated on its findings. In May 2005, corporate management concluded that prior period financial statements could not be relied upon and should be restated. On August 1, 2005, the Company announced that the Audit Committee of the Company s Board of Directors had finished its independent review of accounts receivable and revenue issues in the Company s Asia-Pacific Region. Independent counsel and independent forensic accountants assisted the Audit Committee in its review.

The following summary represents the results of the Company s review including the evaluation of the Audit Committee s findings. Financial information included in this Form 10-K reflects all of the restatements described below.

Sales to Small Bees

The Company s operations in the PRC recognized revenue for sales of inventory that had not been sold. Certain PRC employees took steps to conceal this fact from the Company s auditors by moving inventory between warehouses. As a result, the Company has reversed certain sales transactions improperly recognized as revenue and has now recognized the revenue in the quarter of shipment. Provisions for inventory obsolescence and lower of cost or market adjustments were increased as a result of more inventory being held following the reversal of the sale. (See Note (2) of the accompanying Notes to Consolidated Financial Statements contained in this Form 10-K).

Claims for Credits

As is common practice in the industry, the PRC operations have historically received credits or other forms of compensation from its suppliers, including credits for price protection, volume rebates, incentives for market coverage, and inventory accuracy. The PRC operations have historically received claims for credits for price protection and volume rebates from the Small Bees for products purchased. Previously the Company recorded the credits provided to the Small Bees as a reduction in revenue in the period the credit was processed rather than

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at the time of the initial sale. As a result, the Company s reported revenues in previous periods did not properly include an estimate of the credits to be provided. The Company has restated prior periods to reflect the claims for credit as a reduction in revenues at the time of sale. (See Note (2) of the accompanying Notes to Consolidated Financial Statements contained in this Form 10-K). Management in the PRC failed to follow the Company s policy regarding revenue recognition and the approval of credits.

Extended Trade Terms

At various times since 2000, the PRC operations informally extended trade terms to certain Small Bees. Under these informally extended trade terms, certain Small Bees purchased products from the PRC operations, and the Company believes the proceeds from the subsequent sales of these products were used by the Small Bees to develop new or expand existing wholesale and/or retail operations or to develop new business opportunities. The Company has determined that the recognition of revenue for sales under these terms was not appropriate due to the indefinite nature of the extended credit and the absence of a formal agreement. The Company has determined that revenues on the original sales transactions should not have been recognized until payment is received and has restated prior periods accordingly. (See Note (2) of the accompanying Notes to Consolidated Financial Statements contained in this Form 10-K). The Company s corporate management was not informed that management in the PRC had informally extended credit terms. Management in the PRC failed to follow the Company s policy regarding extension of credit terms and submitted an inaccurate aging and presentation of these trade receivables in the Company s internal financial reporting package which is used for the preparation of quarterly and annual financial statements.

In addition, the review by the Audit Committee concluded:

- In the first quarter of 2004, there were efforts to aggressively promote sales in the PRC in an effort to promote the proposed IPO of the Greater China Operations on the SEHK.

- During the 2004 IPO period, the PRC operations may have sold products to its distributors at prices that were higher than market prices and deferred rebates to inflate revenues. Prior practice had been to price products at the then-prevailing market price.

- There were weaknesses in internal controls related to corporate governance and oversight and also weaknesses related to revenue recognition, rebate claims, inventory, and accounts receivable in the PRC operations. The Audit Committee has asked that management remediate these weaknesses.

The material weakness in internal controls in the Company s PRC operations is more fully described in Item 9A Controls and Procedures.

Business of the Asia-Pacific Region

In the Asia-Pacific Region, the Company offered wireless handsets and accessories manufactured by original equipment manufacturers (OEMs), such as Nokia, Siemens, NEC, Shanghai DBTEL Industry Co. Ltd. (DBTEL) and Motorola and aftermarket accessories manufactured by a variety of suppliers. Throughout the region, the Company acted as a wholesale distributor of wireless handsets to large and small volume purchasers.

CellStar (Asia) Corporation Limited (CellStar Asia), the oldest of the Company s wholly-owned business units in the region, derived its revenue principally from wholesale sales of wireless handsets to Hong Kong-based exporters.

Shanghai CellStar International Trading Co., Ltd. (CellStar Shanghai), a wholly-owned, limited liability foreign trade company established in Shanghai, commenced operations in the PRC in 1997 in the Shanghai Waigaiqiao Bonded Zone. CellStar Shanghai leased warehouse, showroom and office space in the Pudong district of Shanghai, as well as office and warehouse space in both Beijing and Guangzhou and office space in Chengdu.

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The Company s Asia-Pacific Region also included the Taiwan operations. Although the Company s business in the Asia-Pacific Region was predominantly wholesale, retail operations were also conducted in Taiwan. During the fourth quarter of 2004, the Company sold its Singapore operations to a local group which included the former general manager of the operations. As of November 30, 2004 the Company was in the final stages of closing the operations in The Philippines. The Company closed its Korean purchasing office in 2004.

The following table outlines CellStar s Asia-Pacific Region for countries in which operations were conducted in fiscal 2004:

Country	Year Entered	Type of Operation (as of November 30, 2004)
Hong Kong	1993	Wholesale (divested September , 2005)
Singapore	1995	Wholesale (divested as of November 12, 2004)
The Philippines	1995	Wholesale (closed in 2005)
Taiwan	1995	Wholesale and Retail (sales agreement signed August 25, 2005)
People s Republic of China	1997	Wholesale (divested September , 2005)
Korea	2000	Closed in 2004

At November 30, 2004, the Company sold its products to over 200 wholesale customers in the Asia-Pacific Region, the ten largest of which accounted for approximately 22.7% of consolidated revenues. The operations in the Asia-Pacific Region were responsible for approximately 35% of the Company s revenues for fiscal 2004. For the year ended November 30, 2004, the five largest customers of the Asia-Pacific Region accounted for approximately 47.6% of the total revenues of the region.

North American Region

The Company believes growth in the U.S. will be increasingly driven by replacement sales, as penetration approaches 60% in the region. In 2004, the U.S. wireless market saw further consolidation, with several high profile mergers and acquisitions announced. As nationwide carriers get larger and gain market share, smaller wireless carriers are fighting to remain competitive. This smaller, regional carrier segment comprised approximately 44% of the Company s revenues in the North American Region in 2004. Further consolidation in the regional carrier segment could have a material adverse impact on the Company s business.

The Company s North American Region generated operating income of $18.8 million, $13.3 million and $1.5 million for the years ended November 30, 2002, 2003, and 2004, respectively. Although the region continued to be profitable in 2004, the Company underestimated the time it would take to close some of the large reverse logistics programs it was working on, and it did not execute on its strategies to market its new products in 2004. Therefore, the Company has renewed its focus in the areas of new business development and new product development and has reorganized the region. However, the issues relating to the PRC operations and the delayed filing of the Form 10-K for 2004 has hampered the Company s ability to acquire new accounts in 2005. The Company was not successful in its expansion in 2004 into product sales outside of the Company s traditional handset business and incurred obsolescence expense of $3.6 million on three new products offered in 2004. The Company has hired a new general manager of the North American Region and has also hired a new product manager to lead the new product effort. Also as a result of the delayed filing of the Form 10-K and the consolidated operating loss in 2004, the Company has experienced tightening of credit with its vendors, including its primary supplier Motorola during 2005. The tightening of credit has impacted the Company s ability to grow the North America Region. The Company will not be able to significantly grow the business without the availability of additional working capital or credit lines.

The Company offers a broad product mix in the United States, and anticipates that the Company s product offerings will continue to expand with the evolution of new technologies as they become commercially viable.

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The Company distributes products through direct-to-retailer fulfillment, direct-to-consumer fulfillment and direct-to-distributor fulfillment of both handsets and accessories. The Company also offers value-added services such as advanced exchange and other consumer exchange programs, returns management and asset recovery, repair and refurbishment, channel development, warranty claims management, inventory management, inventory purchasing, warehousing, shipping, custom packaging and kitting, programming, one-off fulfillment, channel management systems, web-enabled systems integration solutions and on-line ordering and reporting to its customers. In addition, the Company provides private labeling services for handsets and accessories to several major carriers, and has agreements with certain big-box retailers to supply CellStar-branded accessories.

In the North American Region, the Company offers wireless handsets and accessories manufactured by OEMs, such as Motorola, Kyocera, LG and Nokia and aftermarket accessories manufactured by a variety of suppliers. The Company s revenues in the North American Region are generated primarily from handset and accessory sales. The Company s distribution operations and value-added services complement the manufacturer distribution channels by allowing the manufacturers to distribute their products to smaller volume purchasers and retailers. At November 30, 2004, the Company sold its products to over 1,550 customers in the North American Region, the ten largest of which accounted for approximately 20% of consolidated revenues.

In January 2004, the Company announced that it would cease providing fulfillment and logistics services for one of the region s largest customers, Cricket Communications, Inc. (Cricket), as well as its indirect sales channels, at the expiration of the agreement related to those services. The agreement expired on February 25, 2004. Company management believes that the pricing requested by Cricket going forward would not have met the Company s desired profitability. Revenues from Cricket and its indirect sales channel represented approximately 12% of the Company s consolidated revenues for fiscal 2002 and approximately 7% and 2% in fiscal 2003 and 2004, respectively.

In March 2004, the Company launched its Omnigistics® (patent pending) logistics system. The Omnigistics® system, a comprehensive reverse and forward logistics solution, provides enhanced logistic services and programs designed to meet the most complex wireless business demands. The Omnigistics® system offers asset tracking and management processes, from advanced exchange and direct-to-consumer programs to bulk fulfillment and retail-ready solutions that include kitting, packaging and programming. In combination with centralized returns, the Company offers an on-site repair center to handle refurbishment and repair of handsets. The Company believes that its Omnigistics® system creates valuable efficiencies for its customers, and plans several enhancements in 2005 to make it even easier for wireless carriers, retailers, and manufacturers to offer the most advanced technologies with ease.

The Company continues to develop and enhance the functionality of its OrderStar® and CellStar netXtreme® programs. These programs are proprietary, Internet-based order entry and supply-chain services software and systems designed to assist customers in the submission and tracking of orders and to allow customers to analyze their business activities with CellStar through the creation of customized reports. The OrderStar® system enhances the CellStar customer experience by offering faster product navigation and streamlined checkout procedures, private labeling capabilities, and marketing and advertising opportunities. Together, the OrderStar® and CellStar netXtreme® systems greatly enhance a customer s ability to actively manage inventories and reduce supply-chain delays while reducing the cost to CellStar of fulfilling their orders. Today, over 85% of all orders CellStar receives in the U.S. are in electronic form via the OrderStar® and CellStar netXtreme® systems, XML interconnect or electronic data interchange (EDI). In addition, the Company assists customers in developing e-commerce platforms and solutions designed to enhance sales and reduce product delivery and activation delays.

The Company uses several marketing strategies throughout the North American Region, including trade shows, trade magazine advertising, direct mail, telemarketing, public relations, e-marketing, training programs, rebate promotions and incentive planning and distributing product catalogs and service and program brochures.

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Latin American Region

The Company believes that demand for wireless communications services in the Latin American Region has been and should continue to be driven by an unsatisfied demand for basic phone service due to the lack of adequate landline service and limited wireless penetration. The Company believes that wireless systems in this region offer a more attractive alternative to landline systems because wireless systems do not require the substantial amount of time and investment in infrastructure (in the form of buried or overhead cables) associated with landline systems. However, political and economic instability in the region in recent years in certain of the countries in which the Company maintained operations caused the Company to formulate a strategy to reposition its operations in those areas. In 2002, the Company divested its operations in Peru and Argentina. In 2003, the Company shifted the majority of its business with its major carrier customer in Colombia to the Company s Miami export operations. In the second quarter of 2004, in connection with this strategy, the Company completed the divestiture of its operations in Colombia to a group that included local management. Also in 2003, the Company replaced the general manager in its Mexico operations, revised its business model and focused on supplier and carrier relationships. With the divestiture of the Colombia operations, the Company has completed its repositioning in this region.

In the Latin American Region, operating income (loss) was ($15.0) million, ($5.0) million and $7.6 million for the years ended November 30, 2002, 2003 and 2004, respectively. For fiscal 2004, the region was the Company s largest source of operating income.

In the Latin American Region, CellStar offers wireless handsets, related accessories and other wireless products manufactured by OEMs, such as Motorola, Kyocera, Samsung and Nokia, and aftermarket accessories manufactured by a variety of suppliers to carriers, mass merchandisers and other retailers. The Company, through its Miami, Florida operations, acts as a wholesale distributor of wireless communications products in the Latin American Region to large volume purchasers, such as wireless carriers, as well as to smaller volume purchasers. As a result, the Company s Miami operations are included in the Latin American Region.

The Company s business in the Latin American Region is predominantly wholesale and value-added fulfillment services, including handset programming and software upgrades, packing, stocking, kitting, one-off shipping, procurement, warehousing, and distribution. In addition, the Company conducts retail operations in Mexico and Chile. At November 30, 2004, CellStar operated 36 retail locations (including kiosks) in the Latin American Region, 8 of which were located in Chile and 28 of which were located in Mexico. The Company also sells private label products to two major carriers in Mexico.

The following table outlines CellStar s Latin American Region for countries in which operations were conducted in fiscal 2004:

Country	Year Entered	Type of Operation
		(as of November 30, 2004)
Mexico	1991	Wholesale and Retail
Chile	1993	Service and Repair, Wholesale and Retail
Miami	1993	Wholesale
Colombia	1994	Divested in May 2004

As of November 30, 2004, the Company sold its products to approximately 100 wholesale customers, including subagents, in the Latin American Region. The ten largest customers accounted for approximately 22% of the Company s consolidated revenues in fiscal 2004. The Company offers a broad product mix in the Latin American Region compatible with digital systems and anticipates that its product offerings will continue to expand in the countries in which the Company continues to operate with the evolution of new technologies as such products become commercially viable.

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In April 2005, the Company s subsidiary in Mexico, Celular Express S.A. de C.V. (CELEX), invested in a joint venture with Soluciones Inalambricas S.A. de C.V. (Wireless Solutions) and its individual partners. The joint venture, which operates under the name Comunicacion Inalambrica Inteligente, S.A. de C.V. (CII), provides handset distribution and activation services for Radio Movil Dipsa S.A. de C.V. (Telcel), the largest cellular phone company in Mexico. CELEX owns 51% of CII and the remaining 49% is owned by the individual partners of Wireless Solutions.

The Company markets its products through trade shows, trade magazines, direct sales and advertising. The Company uses direct mailings and newspapers to promote its retail operations. To penetrate local markets, the Company has made use of subagent relationships in certain countries.

Industry Relationships

The Company has established strong relationships with leading wireless equipment manufacturers and wireless service carriers. Although the Company purchased its products from more than 20 suppliers in fiscal 2004, 74% of the Company s purchases were from Motorola (31%), Nokia (29%) and Kyocera (14%). Nokia was the Company s primary supplier in 2004 in the Asia-Pacific Region. The percentage of Nokia products is expected to significantly decrease in 2005 as a result of the Company s decision to exit the Asia-Pacific Region. Kyocera primarily supplied CDMA product for the Latin American Region in 2004. The Company s primary Latin American customers are now using GSM products or are converting to GSM products. Accordingly, purchases from Kyocera are expected to decline in 2005.

The Company has distribution agreements with many of its suppliers, including Motorola, Nokia, Kyocera and Samsung, or their foreign affiliates, that specify territories, pricing and payment terms. These contracts typically provide the Company with price protection, or the right to receive the benefit of price decreases on products currently in the Company s inventory if such products were purchased by the Company within a specified period of time prior to the effective date of the price decrease.

The Company s agreements with its suppliers generally have one-year terms with automatic renewals of successive one-year terms unless notice of non-renewal is given. Other agreements, such as Kyocera and Nokia, expire at various times and must be extended in writing by the parties. The majority of these supplier agreements can be terminated without cause by the terminating party giving notice within periods ranging from 30 to 60 days prior to such termination. The agreement with Kyocera, however, may be terminated only for cause. Most of the agreements with suppliers are non-exclusive.

The Company is required, pursuant to certain supplier agreements, to submit forecasts on either a monthly or a three-month rolling basis. Such estimates are on a best efforts basis. Some suppliers base pricing on volume commitments achieved by the Company.

Although the Company does not have agreements with the majority of its customers, where agreements exist, they generally have terms ranging from one to two years, and can be extended for successive one year terms thereafter. Most agreements can be terminated by either party without cause by the terminating party giving notice within periods ranging from 60 to 90 days prior to such termination. While the Company believes its customer relations are good, there can be no assurance that the Company will retain its current customer base.

Due to the delays in filing the Form 10-K for 2004 and the operating results, the Company has experienced some tightening of credit with its vendors, including its primary supplier Motorola, in the North America and Latin America Regions during 2005. The Company has been able to utilize credit lines available from its suppliers, borrowings under the Company s revolving credit facility, and factoring of accounts receivable to meet its financing needs. The Company is generally able to factor its receivables from the major carriers in the L