MONOLITHIC POWER SYSTEMS INC
Form 10-Q
November 07, 2006
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2006

OR

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

Commission file number: 000-51026

Monolithic Power Systems, Inc.

(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

Delaware	**77-0466789**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification Number)**

983 University Avenue, Building A, Los Gatos, CA 95032 (408) 357-6600

(ADDRESS OF PRINCIPAL EXECUTIVE OFFICES, INCLUDING ZIP CODE AND TELEPHONE NUMBER)

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 x No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act).

Large accelerated filer ¨ Accelerated filer x Non-accelerated filer ¨

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

There were 30,285,338 shares of the registrant s common stock issued and outstanding as of October 31, 2006.

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MONOLITHIC POWER SYSTEMS, INC.

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

MONOLITHIC POWER SYSTEMS, INC.

CONDENSED CONSOLIDATED BALANCE SHEET

(in thousands)

(Unaudited)

	September 30, 2006	December 31, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 30,479	$ 25,091
Short-term investments	39,650	38,814
Accounts receivable, net of allowances of $227 at 2006 and 2005	9,577	9,537
Inventories	7,385	6,165
Deferred income tax asset current	3,516	3,671
Prepaid expenses and other current assets	1,094	1,501
Restricted assets current	3,850	2,938
Total current assets	95,551	87,717
Property and equipment, net	11,247	6,238
Other assets non-current	469	387
Restricted assets non-current	6,387	6,433
Total assets	$ 113,654	$ 100,775
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 5,472	$ 6,583
Accrued compensation and related benefits	3,493	2,974
Accrued income tax payable		2,913
Accrued liabilities	11,618	9,797
Total current liabilities	20,583	22,267
Deferred rent	355	209
Other accrued liability	1,000	
Deferred income tax liability		131
Total liabilities	21,938	22,607
Stockholders equity:		
Common stock, $0.001 par value, $30 and $29 in 2006 and 2005, respectively; shares authorized: 150,000; shares issued and outstanding: 30,185 and 29,156 in 2006 and 2005, respectively	108,916	98,342
Deferred stock compensation	(801)	(4,544)
Notes receivable from stockholders		(398)
Accumulated other comprehensive loss	(85)	(138)

Accumulated deficit		(16,314)		(15,094)
Total stockholders equity		91,716		78,168
Total liabilities and stockholders equity	$	113,654	$	100,775

See accompanying notes to condensed consolidated financial statements.

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MONOLITHIC POWER SYSTEMS, INC.

CONDENSED CONSOLIDATED STATEMENT OF OPERATIONS

(in thousands, except per share amounts)

(Unaudited)

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2006	**2005**	**2006**	**2005**
Revenue	$ 27,255	$ 29,706	$ 78,619	$ 66,600
Cost of revenue (including stock-based compensation of $121 and $408 for the three and nine months ended September 30, 2006 and $130 and $390 for the three and nine months ended September 30, 2005)	9,382	10,593	28,588	24,307
Gross profit	17,873	19,113	50,031	42,293
Operating expenses:				
Research and development (including stock-based compensation of $1,330 and $4,039 for the three and nine months ended September 30, 2006 and $569 and $2,045 for the three and nine months ended September 30, 2005)	5,897	4,045	16,391	10,980
Selling, general and administrative (including stock-based compensation of $1,518 and $4,293 for the three and nine months ended September 30, 2006 and $450 and $1,733 for the three and nine months ended September 30, 2005)	6,877	4,880	21,003	12,963
Patent litigation	5,765	(4,488)	12,650	17,382
Total operating expenses	18,539	4,437	50,044	41,325
Income (loss) from operations	(666)	14,676	(13)	968
Other income (expense):				
Interest and other income	662	401	1,887	1,094
Interest and other expense	(71)	(74)	(251)	(160)
Total other income (expense), net	591	327	1,636	934
Income (loss) before income taxes	(75)	15,003	1,623	1,902
Income tax provision	1,797	5,641	2,844	628
Net income (loss)	$ (1,872)	$ 9,362	$ (1,221)	$ 1,274
Basic income (loss) per common share	$ (0.06)	$ 0.33	$ (0.04)	$ 0.05
Diluted income (loss) per common share	$ (0.06)	$ 0.31	$ (0.04)	$ 0.04
Shares used in basic net income (loss) per common share	29,736	28,093	29,335	27,794
Dilutive effect of stock options and restricted stock		2,549		2,569
Shares used in diluted net income (loss) per common share	29,736	30,642	29,335	30,363

See accompanying notes to condensed consolidated financial statements.

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MONOLITHIC POWER SYSTEMS, INC.

CONDENSED CONSOLIDATED STATEMENT OF CASH FLOWS

(in thousands)

(Unaudited)

	Nine Months Ended September 30,	
	2006	**2005**
Cash flows from operating activities:		
Net (loss) income	$ (1,221)	$ 1,274
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation	1,963	1,267
Loss on disposal of property and equipment	55	
Deferred income taxes	155	(1,286)
Tax benefit related to stock-based compensation	1,401	386
Excess tax benefit from stock option transactions	(1,164)	
Stock-based compensation	8,740	4,147
Changes in operating assets and liabilities:		
Accounts receivable	(32)	(5,765)
Inventories	(1,220)	(318)
Prepaid expenses and other assets	337	532
Accounts payable	(1,745)	2,599
Accrued liabilities	2,861	5,204
Accrued tax payable	(2,915)	1,149
Accrued compensation and related benefits	435	2,471
Deferred tax liabilities	(131)	
Deferred rent	173	57
Net cash provided by operating activities	7,692	11,717
Cash flows from investing activities:		
Property and equipment purchases	(6,325)	(1,684)
Proceeds from sale of assets	1	1
Purchases of investments	(49,980)	(86,200)
Proceeds from sale of investments	49,143	87,725
Change in restricted assets	(912)	(2)
Net cash used in investing activities	(8,073)	(160)
Cash flows from financing activities:		
Proceeds from stockholder note receivable	398	
Proceeds from issuance of common stock	2,966	1,362
Proceeds from employee stock purchase plan	1,209	(15)
Excess tax benefits from exercise of stock options	1,164	
Net cash provided by financing activities	5,737	1,347
Effect of change in exchange rates	32	(105)
Net increase in cash and cash equivalents	5,388	12,799
Cash and cash equivalents, beginning of period	25,091	32,019

Cash and cash equivalents, end of period	$ 30,479	$ 44,818
Supplemental disclosures of cash flow information:		
Income tax paid	$ 4,607	$ 269
Supplemental disclosures of non-cash investing and financing activities:		
Liability accrued for equipment purchase	$ 623	$ 33
Unrealized loss on investments	$	$ (16)
Restricted stock and stock options granted at less than fair market value	$ 1,188	$ 2,207

See accompanying notes to condensed consolidated financial statements.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. ***Basis of Presentation*** The accompanying unaudited condensed consolidated financial statements have been prepared by Monolithic Power Systems, Inc. (the Company or MPS) in accordance with the rules and regulations of the Securities and Exchange Commission (the SEC). Certain information and disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted in accordance with these rules and regulations. The information in this report should be read in conjunction with the Company s audited consolidated financial statements and notes thereto included in its Form 10-K filed with the SEC on March 28, 2006.

In the opinion of management, the accompanying unaudited consolidated financial statements reflect all adjustments (consisting only of normal recurring adjustments) necessary to summarize fairly the Company s financial position, results of operations and cash flows for the interim periods presented. The financial statements contained in this Form 10-Q are not necessarily indicative of the results that may be expected for the year ending December 31, 2006 or for any other future period.

2. ***Stock-Based Compensation*** Effective January 1, 2006, the Company adopted the provisions of Statement of Financial Accounting Standards (SFAS) No. 123(R), Share-Based Payment (SFAS 123(R)). SFAS 123(R) establishes accounting for stock-based awards based on the fair value of the award measured at grant date. Accordingly, stock-based compensation cost is recognized as an expense over the requisite service period. The Company previously recognized expense in accordance with Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations and provided the required pro forma disclosures of SFAS No. 123, Accounting for Stock-Based Compensation (SFAS 123). The Company elected to adopt the modified prospective application method as provided by SFAS 123(R). Under the modified prospective method, prior period results are not restated. The fair value of (i) stock options granted after December 31, 2005 and (ii) the unvested portion of stock options granted after the Company s initial filing of its registration statement on Form S-1 on July 13, 2004 for its initial public offering and before the adoption of SFAS 123(R) are recognized as compensation expense using the Black-Scholes option pricing method. Stock options granted prior to July 13, 2004, the date the Company became a public company, will continue to be accounted for and recognized as compensation expense using the intrinsic value method under APB Opinion No. 25 and related interpretations as required under SFAS 123(R). Prior to the adoption of SFAS No. 123(R), tax benefits in excess of compensation cost recognized were reported as operating cash flows. SFAS No. 123(R) requires excess tax benefits to be reported as a financing cash flow rather than as a reduction of taxes paid.

At September 30, 2006, the Company had two stock option plans and an employee stock purchase plan the 1998 Stock Option Plan, the 2004 Equity Incentive Plan and the 2004 Employee Stock Purchase Plan (ESPP Plan). For the three and nine months ended September 30, 2006, the Company s net loss was $1.9 million and $1.2 million, respectively. This included $3.0 million and $8.7 million, respectively, of stock-based compensation expense.

1998 Stock Option Plan

Under the Company s 1998 Stock Option Plan (the 1998 Plan), the Company reserved 11,807,024 shares of common stock for issuance to the Company s employees, directors and consultants. Options granted under the 1998 Plan had a maximum term of 10 years and generally vest over four years at the rate of 25 percent one year from the date of grant and 1/48th monthly thereafter. The Plan provided for the granting of incentive stock options and nonstatutory stock options at a per share price of not less than 100% of the fair market value of the underlying stock at the grant date. However, when incentive stock options or nonstatutory stock options were granted to an employee, director or consultant who, at the time of grant, owned stock representing more than 10% of the voting power of all classes of stock, the exercise price per share was no less than 110% of the fair market value of the underlying stock on the date of grant. On November 19, 2004, the effective date of the Company s initial public offering, the 1998 Plan was closed for future grants and the remaining 1,392,750 shares available for grant were moved to the Company s 2004 Equity Incentive Plan.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Continued) (Unaudited)

2004 Equity Incentive Plan

The Company s Board of Directors approved the 2004 Equity Incentive Plan (the 2004 Plan) in March 2004. The Plan was subsequently approved by the Company s stockholders in November 2004. Options granted under the 2004 Plan generally vest over four years at the rate of 25 percent one year from the date of grant date and 1/48th monthly thereafter. There were 800,000 shares initially reserved for issuance under the 2004 Plan. The 2004 Plan provides for annual increases in the number of shares available for issuance beginning on January 1, 2005 equal to the least of: 5% of the outstanding shares of common stock on the first day of the year, 2,400,000 shares, or a number of shares determined by the Board of Directors. Effective January 1, 2006, 1,457,786 shares were added to the 2004 Plan. As of September 30, 2006, 1,892,974 shares were available for future option grants.

Prior to the Company s adoption of SFAS 123(R), the Company accounted for stock-based awards to employees under the recognition and measurement principles of APB Opinion No. 25 and related interpretations. The Company amortized deferred stock-based compensation over the vesting period of the option, which is generally four years, in accordance with FASB Interpretation No. 28, *Accounting for Stock Appreciation Rights and* Other Variable Stock Option or Award Plans, an interpretation of APB Opinion No. 25.

A summary of the status of our stock option plans at September 30, 2006 and changes during the nine months then ended is presented in the table below:

	Stock Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value
Outstanding at December 31, 2005	8,379,216	$ 5.87		
Options granted	1,687,500	15.03		
Options exercised	(772,537)	3.59		
Options forfeited	(394,717)	11.20		
Options expired	(1,858)	10.00		
Outstanding at September 30, 2006	8,897,604	$ 7.57	7.49	$ 27,403,011
Options exercisable at September 30, 2006 and expected to become exercisable	8,897,604	$ 7.57	7.49	$ 27,403,011
Options vested and exercisable at September 30, 2006	4,319,229	$ 4.66	6.50	$ 21,299,826

The total fair value of options that vested during the three and nine months ended September 30, 2006 was $2.6 million and $7.8 million, respectively. The total intrinsic value of options exercised during the three and nine months ended September 30, 2006 was $0.9 million and $9.6 million, respectively. Net cash proceeds from the exercise of stock options were $0.3 million and $2.8 million for the three and nine months ended September 30, 2006, respectively.

The employee stock-based compensation expense recognized under SFAS 123(R) and presented in the pro forma disclosure required under SFAS 123 was determined using the Black-Scholes option pricing model. Option pricing models require the input of subjective assumptions and these assumptions can vary over time. The Company used the following weighted-average assumptions to determine stock-based compensation expense:

	Three months ended	Nine months ended

	September 30, 2006	September 30, 2005	September 30, 2006	September 30, 2005
Expected term (years)	4.53	6.50	4.92	6.42
Expected volatility	54.75%	69.78%	62.30%	64.62%
Risk-free interest rate	4.89%	4.22%	4.73%	4.22%
Dividend yield				

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Continued) (Unaudited)

In estimating the expected term, the Company considered its historical stock option exercise experience, post vesting cancellations and remaining contractual term of the options outstanding. The estimated expected volatility was based on the historical stock prices of companies similar to MPS, as the Company does not have sufficient historical data as a public company to determine reasonable estimates. MPS considered companies of similar size, industry and financial structure to devise its estimate. The Company uses the U.S. Treasury yield for its risk-free interest rate and a dividend yield of zero as it does not issue dividends.

At September 30, 2006, unamortized compensation expense related to unvested options was approximately $17.4 million. The weighted average period over which compensation expense related to these options will be recognized is approximately 1.67 years.

2004 Employee Stock Purchase Plan

The Employee Stock Purchase Plan (the Purchase Plan) became effective on the closing of the Company s initial public offering. The Purchase Plan allows employees to purchase the Company s common stock at 85 percent of the fair value at certain specified dates. Participants may not purchase (i) more than 2,000 shares in a six-month offering period or (ii) stock having a value greater than $25,000 in any calendar year as measured at the beginning of the offering period in accordance with the Internal Revenue Code and applicable Treasury Regulations. A total of 200,000 shares of common stock were reserved for issuance under the Purchase Plan. The Purchase Plan provides for annual automatic increases beginning on January 1, 2005 by an amount equal to the least of: 1,000,000 shares, 2% of the outstanding shares of common stock on the first day of the year, or a number of shares as determined by the Board of Directors. In January 2006, the number of shares available for future issuance under the Purchase Plan was increased by 583,114 shares. For the three and nine months ended September 30, 2006, 87,119 and 172,037 shares, respectively, were issued. As of September 30, 2006, there were 1,069,978 shares available for issuance under the Purchase Plan.

The Purchase Plan is considered compensatory under SFAS 123(R) and is accounted for in accordance with Financial Accounting Standards Board (FASB) Technical Bulletin 97-1 (FTB97-1) *Accounting under Statement 123 for Certain Employee Stock Purchase Plans with a Look-Back Option*. The compensation expense for the three and nine months ended September 30, 2006 was $0.2 million and $0.3 million, respectively. There were no compensation expenses related to the Company s ESPP for the three and nine months ended September 30, 2005. The Black-Scholes option pricing model was used to value the employee stock purchase rights. For the three and nine months ended September 30, 2006, the following assumptions were used in the valuation of the stock purchase rights:

	Three months ended		Nine months ended	
	September 30, 2006	September 30, 2005	September 30, 2006	September 30, 2005
Expected term (years)	0.50	0.58	0.50	0.58
Expected volatility	50.91%	39.91%	50.17%	39.91%
Risk-free interest rate	5.24%	3.83%	4.84%	3.83%
Dividend yield				

Restricted Stock

A portion of the Company s shares of common stock were issued under restricted stock purchase agreements. Under these agreements, in the event of termination of the employees, the Company has the right to repurchase the common stock at the original issuance price. The repurchase right expires over a 48 month period. At September 30, 2006, there were 308,986 shares subject to repurchase with a weighted average exercise price of $0.001 per share and a weighted average grant date fair value of $10.57 per share. At September 30, 2005, there were 322,102 shares subject to repurchase with a weighted average exercise price of $0.001 per share and a weighted average grant date fair value of $8.36 per share. The compensation expense related to restricted stock was $273,000 and $327,000 for the three months ended September 30, 2006 and 2005, respectively, and $636,000 and $899,000 for the nine months ended September 30, 2006 and 2005, respectively.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Continued) (Unaudited)

Pro Forma Information for Period Prior to Adoption of SFAS 123(R)

The following pro forma net loss and net loss per share were determined as if the Company had accounted for employee stock-based compensation for its employee stock plans under the fair value method prescribed by SFAS 123, *Accounting for Stock-Based Compensation* (in thousands, except per share amounts):

	Three months ended September 30, 2005		Nine months ended September 30, 2005	
Net income, as reported	$	9,362	$	1,274
Add stock-based employee compensation included in net income		731		2,637
Less stock-based employee compensation expense determined under the fair value method, net of tax		(1,724)		(4,967)
Pro forma net income (loss)	$	8,369	$	(1,056)
Basic net income (loss) per share:				
As reported	$	0.33	$	0.05
Pro forma	$	0.30	$	(0.04)
Diluted net income (loss) per share:				
As reported	$	0.31	$	0.04
Pro forma	$	0.27	$	(0.04)

Non-Employee Stock-Based Compensation

The Company accounts for stock-based compensation related to equity instruments issued to non-employees in accordance with Emerging Issues Task Force No. 96-18, *Accounting for Equity Instruments that are Issued to Other than Employees for Acquiring or in Conjunction with Selling Goods or Services.* The Company grants stock options to its consultants in exchange for services. The fair value of the vested portion of the grant is expensed over the service period. The compensation expense related to non-employees was ($62,000) and $15,000 for the three months ended September 30, 2006 and 2005, respectively, and ($7,000) and $86,000 for the nine months ended September 30, 2006 and 2005, respectively. The Black-Scholes option pricing model was used to value the non-employee options, using the following assumptions:

	Three months ended		Nine months ended	
	September 30, 2006	September 30, 2005	September 30, 2006	September 30, 2005
Expected term (years)	6.90	7.90	7.15	8.12
Expected volatility	63.69%	69.78%	66.75%	63.88%
Risk-free interest rate	4.85%	4.21%	4.80%	4.26%
Dividend yield				

3. Inventories - Inventories are stated at the lower of standard cost (which approximates actual cost on a first-in, first-out basis) or market and includes material, labor and manufacturing overhead costs. Inventories consist of the following (in thousands):

	September 30, 2006		December 31, 2005	
Work in progress	$	2,672	$	2,516
Finished goods		4,713		3,649

Total inventories	$ 7,385	$ 6,165

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Continued) (Unaudited)

4. Accrued Liabilities - Accrued liabilities consist of the following (in thousands):

	September 30, 2006	December 31, 2005
Legal expense and settlement costs	$ 7,151	$ 7,297
Professional fees	1,081	731
Warranty	1,204	490
Deferred Revenue	1,200	266
Other	982	1,013
Total accrued liabilities	$ 11,618	$ 9,797

5. Comprehensive Loss and Net Loss per Share Basic Net Income (Loss) per Share is computed based on the weighted average number of common shares outstanding during the period and does not include the dilutive effect of common equivalent shares, such as stock options. Diluted Net Income per Share is computed based on both the weighted average number of common shares outstanding during the period and the dilutive effect of common equivalent shares, such as stock options.

For the nine months ended September 30, 2006 and 2005, the Company had securities outstanding, that could potentially dilute basic earnings per share in the future, but were excluded in the computation of diluted Net Loss per share in the periods presented, as their effect would have been antidilutive. The shares of common stock issuable upon conversion or exercise of such outstanding securities consist of the following (in thousands):

	Nine months ended September 30,	
	2006	2005
Stock options	8,898	2,978
Restricted stock	309	
Total	9,207	2,978

The Company s comprehensive loss includes unrealized holding gains (losses) on available-for-sale securities and foreign currency translation adjustments. The following table sets forth the components of other comprehensive income (loss), net of income tax (in thousands):

	Three months ended		Nine months ended	
	September 30, 2006	September 30, 2005	September 30, 2006	September 30, 2005
Net income (loss)	$ (1,872)	$ 9,362	$ (1,221)	$ 1,274
Other comprehensive income (loss):				
Unrealized holding losses on available-for-sale securities		(4)		(16)
Foreign currency translation adjustments	(108)	(288)	55	(294)
Comprehensive income (loss)	$ (1,980)	$ 9,070	$ (1,166)	$ 964

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Continued) (Unaudited)

6. ***Income Taxes***

The Company computes income taxes for interim reporting purposes using estimates of the effective annual income tax rate for the entire fiscal year. This process involves estimating the full-year tax liability and assessing the temporary differences between the book and tax entries. These temporary differences result in deferred tax assets and liabilities, which are recorded on the Company s Condensed Consolidated Balance Sheet in accordance with SFAS No. 109, *Accounting for Income Taxes*, which established financial accounting and reporting standards for the effect of income taxes. The Company must assess the likelihood that its deferred tax assets will be recovered from future taxable income and, to the extent the Company believes that recovery is not likely, the Company must establish a valuation allowance. Changes in the Company s valuation allowance in a period are recorded through the Income Tax Provision on the Consolidated Statement of Operations.

As of September 30, 2006 and December 31, 2005, the Company had a valuation allowance of $2.6 million and $2.1 million, respectively, attributable to management s determination that a portion of the deferred tax assets associated with certain stock based compensation transactions will not be realized. Changes in the Company s valuation for the nine month period ended September 30, 2006 were recorded through the income tax provision in the Condensed Consolidated Statement of Operations.

The provision for income taxes was calculated based on the Company s estimate of its effective tax rate for the full year. At September 30, 2006, the Company s estimate of its effective tax rate for the year ending December 31, 2006 was approximately 81%, but the inclusion of the tax effects of one-time litigation settlements yields a year-to-date calculated tax provision of 175% or $2.8 million. The estimated effective tax rate increased from the second quarter estimated tax rate of 66% because of an increase in stock-based compensation expense, which is not tax deductible, a change in future estimated taxable income and other elements associated with the implementation of the Company s international tax structure.

The Company adopted SFAS 123(R) as of January 1, 2006 and, as a result, incurred significant stock-based compensation expense, some of which related to incentive stock options for which no corresponding tax benefit is recognized unless a disqualifying disposition occurs. Disqualifying dispositions result in a reduction of income tax expense in the quarter when the disqualifying disposition occurs in an amount equal to the tax benefit relating to previously recognized stock compensation expense. Tax benefits related to tax deductions in excess of previously expensed stock compensation are recorded as an addition to paid-in-capital.

7. ***Segment Information***

As defined by the requirements of SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*, the Company operates in one reportable segment: the design, development, marketing and sale of high-performance, mixed-signal analog semiconductors for the computing, consumer electronics, and wireless markets. Geographic revenue is based on the location to which customer shipments are delivered. For the three and nine months ended September 30, 2006, the Company derived substantially all of its revenue from sales to customers located outside North America. The following is a list of customers whose sales exceeded 10% of revenue for the three and nine months ended September 30, 2006 and 2005:

	Three months ended September 30,		**Nine months ended September 30,**	
Customers	**2006**	**2005**	**2006**	**2005**
A	13%	22%	17%	21%
B	13%	12%	13%	12%
C	*%	18%	*%	21%
D	14%	*%	11%	*%

The following is a summary of revenue by geographic region based on customer ship-to location (in thousands):

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Continued) (Unaudited)

Country	Three months ended September 30, 2006	Three months ended September 30, 2005	Nine months ended September 30, 2006	Nine months ended September 30, 2005
China	$ 14,201	$ 15,456	$ 36,726	$ 33,487
Taiwan	4,245	7,811	18,565	18,489
Korea	3,245	3,812	8,728	8,637
Europe	1,873	243	4,776	522
Japan	1,265	1,033	4,599	2,992
USA	1,871	612	3,831	1,442
Other	555	739	1,394	1,031
Total	$ 27,255	$ 29,706	$ 78,619	$ 66,600

The following is a summary of revenue by product type (in thousands):

Product Family	Three months ended September 30, 2006	Three months ended September 30, 2005	Nine months ended September 30, 2006	Nine months ended September 30, 2005
DC to DC Converters	18,820	$ 18,501	$ 54,453	$ 38,970
LCD Backlight Inverters	7,425	10,140	21,809	25,321
Audio Amplifiers	1,010	1,065	2,357	2,309
Total	$ 27,255	$ 29,706	$ 78,619	$ 66,600

The following is a summary of long-lived assets by geographic region, excluding restricted assets (in thousands):

Country	September 30, 2006	December 31, 2005
China	$ 6,692	$ 2,059
United States	4,593	4,148
Other	174	167
Total	$ 11,459	$ 6,374

8. ***Litigation***

O2 Micro, Inc.

Since November 2000, the Company has been engaged in multiple legal proceedings with O2 Micro, Inc. and its parent corporation, O2 Micro International Limited (referred to hereinafter as O2). These proceedings involve various claims and counterclaims in the United States and Taiwan alleging patent infringement, trade secret misappropriation, and unfair competition. All of these claims relate to the Company s CCFL backlight inverter products, which are part of the Company s LCD backlight inverter family. For a more complete description of the litigations, please see Part I, Item 3 of the Company s Form 10-K filed with the Securities and Exchange Commission on March 28, 2006 and Part II, Item 1 of the Company s Form 10-Q filed with the Securities and Exchange Commission on August 4, 2006.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Continued) (Unaudited)

There are two cases pending in the U.S.:

The first case is now on appeal to the United States Court of Appeals for the Federal Circuit. A provision for litigation in the amount of $3.5 million has been set aside for this matter. The Company will continue to incur substantial legal expenses in connection with the appeals in this case. If O2 were to be successful on any appeals from the judgments, the initial jury award of $12 million, which was subsequently overturned, could be reinstated and/or O2 s claims could be remanded for further proceedings. Rulings against the Company on any of these issues on retrial could result in an award of damages to O2 or an injunction against selling the Company s CCFL products in the U.S. Any such injunction could have a material adverse effect on the Company s business and results of operations. To date, direct sales of the Company s CCFL products in the U.S. have not been significant.

The second case is now pending in the United States District Court for the Northern District of California. In this action, O2 alleged that certain of the Company s CCFL products and several of the Company s indirect customers and supplier infringe O2 s 722 patent and that the Company and its CEO, Michael Hsing, engaged in unfair competition The Company is defending and indemnifying some of these defendants. One of the defendants, Compal Electronics, has filed cross-claims for indemnity against the Company and a third party, Delta Electronics. The Company filed a counterclaim against Delta Electronics and O2 for wrongful trade secret misappropriation and unfair competition. Trial is currently scheduled for April 30, 2007. At this time, the Company is not able to reasonably estimate the probability of loss or the range of possible loss in this case.

In addition to the U.S. litigation described above, O2 has brought various legal proceedings against the Company in Taiwan based upon a Taiwan patent. Unlike the U.S., where a party seeking a preliminary injunction must first file a lawsuit on the merits of the underlying claim, in Taiwan it is possible for a party to be granted a preliminary injunction without first filing a lawsuit on the merits. In January 2003, a court in Taiwan issued a preliminary injunction prohibiting the Company from manufacturing, designing, displaying, importing or selling the Company s MP1011A and MP1015 products in Taiwan, either directly or through a third party acting at the Company s request. The Company is pursuing various legal avenues to remove the preliminary injunction and/or have O2 s Taiwan patent declared invalid.

The Company has obtained two counter-injunctions from the Taiwan courts against O2, one of which prohibits O2 from interfering with the Company s or other parties manufacture, sale, use or importation, by either the Company or a third party, of certain of the Company s CCFL products. The Company posted cash bonds of approximately $6.1 million, which are currently recorded as restricted assets on the Company s balance sheet. In addition, during 2003 and 2004, two Taiwan courts granted three provisional seizures against the Company which would entitle O2 to seize up to approximately $1.9 million of the Company s assets in Taiwan. On October 2, 2006, O2 requested that the court seize the Company s bank account with approximately $0.4 million cash. The Company is in the process of posting a bond in the approximate amount of $1.8 million to have its assets released and to avoid further seizures until the matter with O2 is resolved. If the Company does not prevail at trial, the Company might have to forfeit some or all of these bonds. Any such forfeiture would be an expense in the quarter in which the outcome of the trial is probable and reasonably estimable which may materially and adversely affect the Company s results of operations and financial position for that quarter. The Company is not currently able to reasonably estimate the probability of loss or the range of possible loss in the Taiwan matters discussed above.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Continued) (Unaudited)

Taiwan Sumida Electronics

In August 2005, the Company sued TSE and was countersued by TSE for material breach of the indemnity agreement seeking, among other things, reimbursement of attorney fees paid by the Company to TSE s attorneys. If the Company does not win this litigation, it could be required to reimburse TSE for the amount of any final judgment obtained by O2 against TSE and other damages TSM may claim in the future resulting from the Company s termination of the indemnity agreement. Trial is currently scheduled for July 9, 2007. The Company is not currently able to reasonably estimate the probability of loss or the range of possible loss in this case.

Micrel Corporation

Micrel filed an action in November 2004 in the United States District Court for the Northern District of California for alleged patent infringement, misappropriation of trade secrets, common law misappropriation, and unfair competition against the Company and for alleged misappropriation of trade secrets, common law misappropriation, breach of confidentiality agreements and unfair competition against Michael Hsing, the Company s CEO, and Jim Moyer, the Company s chief design engineer, both of whom are former Micrel employees. On September 21, 2006, the Company reached a settlement of the patent infringement and trade secret misappropriation lawsuit brought by Micrel. In the settlement, the parties agreed to dismiss all claims and counterclaims in the litigation with prejudice, and Micrel agreed to license to MPS, and not to assert the patents-in-suit against the Company or its customers in the future. Micrel also agreed to release Michael Hsing, the Company s chief executive officer, and Jim Moyer, the Company s chief design engineer, from all claims for any alleged trade secret claims based on any confidential information. In return, the Company agreed to pay Micrel $3 million in three equal installments in each of 2006, 2007 and 2008, of which $1 million was paid in September 2006. The $3 million settlement was charged to patent litigation expense in the three months ended September 30, 2006.

Linear Technology Corporation

On August 3, 2006, Linear Technology (Linear) filed an action in the United States District Court for the District of Delaware. Linear alleges that the Company s newly introduced Synchronous Rectified Step-Up Converter (MPS 1543) infringes Linear s 178 and 258 patents and constitutes a breach of the Settlement and License Agreement dated October 1, 2005. The Company is investigating the claims involved in this allegation. The Company is not able to reasonably determine the risk of any losses or estimate the range of possible losses in this case.

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ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

This quarterly report on Form 10-Q contains forward-looking statements that involve many risks and uncertainties. These statements relate to future events and our future performance and are based on current expectations, estimates, forecasts and projections about the industries in which we operate and the beliefs and assumptions of our management. These include statements concerning:

- the above-average industry growth of product and market areas that we have targeted,
- our plan to introduce additional new products within our existing product families as well as in new product categories
- our expectation that we will derive increased revenue from new products and our LCD Backlight Inverter and Audio Amplifiers product families,
- seasonality in the markets in which we sell our products,
- increasing diversity in our product mix,
- the factors that we believe will impact our ability to achieve revenue growth,
- expectations of, and provisions for, future income taxes, and
- estimates of our future liquidity requirements.

You can identify forward-looking statements by terms such as would, could, may, will, should, expect, intend, plan, anticipate, believe, estimate, predict, potential, targets, seek, or continue, the negative of these terms or other variations of such terms. These statements are only predictions based upon assumptions that we believe to be reasonable at the time made, and are subject to risks and uncertainties. Therefore, actual events or results may differ materially and adversely from those expressed in any forward-looking statement. In evaluating these statements, you should specifically consider the risks described below in the section entitled Risk Factors. These factors may cause our actual results to differ materially from any forward-looking statements. Except as required by law, we undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

Overview

We are a fabless semiconductor company that designs, develops, and markets proprietary, advanced analog and mixed-signal integrated circuits (ICs). We currently offer products that serve multiple markets, including notebook computers, flat panel displays, cellular handsets, digital cameras, wireless local area network (LAN) access points, home entertainment systems, and personal digital assistants, among others. We believe that we differentiate ourselves by offering integrated circuit solutions that are more highly integrated, smaller in size, more energy efficient, more accurate with respect to performance specifications and, consequently, more cost-effective than many competing solutions. We plan to introduce additional new products within our existing product families, as well as in new product categories.

We derive a majority of our revenue from the sales of our DC to DC converter product family which services the computing, consumer electronics and wireless markets. In the future, we expect increased revenue from the sales of our other products, including our anticipated new product offerings. We believe our ability to achieve revenue growth will depend, in part, on our ability to develop new products, enter new market segments, gain market share, manage litigation risk, diversify our customer base and successfully secure manufacturing capacity.

We operate in the cyclical semiconductor industry. While we will not be immune from future industry downturns, we have targeted product and market areas that we believe have the ability to offer above average industry growth over the long term. In addition, we currently operate as a fabless company, working with third parties to manufacture and assemble our integrated circuits. This has enabled us to limit our capital expenditures and fixed costs, while focusing our engineering and design resources on our core strengths.

Following the introduction of a product, our sales cycle generally takes six to twelve months to complete. Volume production is usually achieved in three to six months after we receive an initial customer order for a new product. Typical lead times for orders are fewer than 90 days. These factors, combined with the fact that orders in the semiconductor industry can typically be cancelled or rescheduled without significant penalty to the customer, make the forecasting of our orders and revenue challenging.

We sell our ICs primarily through distribution arrangements and through our direct sales and applications support organization to original design manufacturers and electronic manufacturing service providers. During the three months ended September 30, 2005, our top three customers made up 52% of our total sales. During the same period in 2006, our top three customers made up 40% of our total sales. This is due to the diversification of our customer base. See Note 7 to the Condensed Consolidated Financial Statements.

We derived 93% and 95% of our revenue from sales to foreign customers during the three and nine months ended September 30, 2006, respectively. The vast majority of this revenue was from direct sales or sales through distribution arrangements to parties located in Asia, where the components we produce are incorporated into an end-user product. Revenues for the three months ended September 30, 2006 decreased by 8% over the same period in 2005 primarily due to a decrease in demand of our LCD backlight inverter products which is primarily a result of increased competition, our lawsuit with O2 Micro and some customers qualifying second sources for backlight inverter products. However, our revenues for the nine months ended September 30, 2006 increased 18% over the same period in 2005. This was due to an increase in the demand of our DC to DC converter products in the consumer electronic communications market. Gross margins for the three and nine months ended September 30, 2006 were 66% and 64%, respectively. The increase in our margins resulted from a change in product mix and efficiencies in test costs as a result of the ramp-up of our Chengdu operations in 2006. Income taxes were $1.8 million and $2.8 million, respectively, for the three and nine months ended September 30, 2006 based on our current 2006 estimated effective tax rate of 81%. For the three and nine months ended September 30, 2006, we had a net loss of $1.9 million and $1.2 million, respectively. This was primarily due to a $3.0 million settlement with Micrel that we recorded in September 2006. For the same period in 2005, we had net income of $9.4 million and $1.3 million, respectively. This was primarily due to the reversal of $8.8 million of a $12.0 million patent litigation provision in the third quarter of 2005. For more details, see Results of Operations.

Critical Accounting Policies and Estimates

Our discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the U.S. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amount of assets, liabilities, revenue and expenses, and related disclosure of contingent assets and liabilities. We evaluate our estimates on an on-going basis, including those related to uncollectible accounts receivable, inventories, income taxes, warranty obligations, contingencies, litigation and valuation of stock-based compensation. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making the judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Estimates and judgments used in the preparation of our financial statements are, by their nature, uncertain and unpredictable, and depend upon, among other things, many factors outside of our control, such as demand for our products and economic conditions. Accordingly, our estimates and judgments may prove to be incorrect and actual results may differ, perhaps significantly, from these estimates under different estimates, assumptions or conditions.

We believe our critical accounting policies are as follows:

Revenue Recognition. We recognize revenue in accordance with Staff Accounting Bulletin No. 104, *Revenue Recognition* (SAB 104) issued by the Staff of the SEC. SAB 104 requires that four basic criteria must be met before revenue can be recognized: (1) persuasive evidence of an arrangement exists; (2) delivery has occurred or services have been rendered; (3) the fee is fixed and determinable; and (4) collectibility is reasonably assured. Determination of criteria (3) and (4) are based on management s judgment regarding the fixed nature of the fee charged for products delivered and the collectibility of those fees. The application of these criteria has resulted in our recognizing revenue upon shipments (when title passes) to customers. Should changes in conditions cause management to determine these criteria are not met for certain future transactions, revenue recognized for any reporting period could be adversely impacted.

The majority of our sales are made through distribution arrangements with third parties. Except for sales to our U.S. distributor, we recognize revenue upon our shipment to those third party distributors. Some of these arrangements include limited stock rotation rights that permit the return of a small percent of the purchases made over the previous six months. As of September 30, 2006 we established a sales return reserve for those stock rotation rights. Our normal payment terms with our distributors are 30 days from invoice date, and our arrangements with our largest distributors generally do not include price protection provisions. In addition, the terms in a majority of our distribution agreements include the non-exclusive right to sell, and the agreement to use best efforts to promote and develop a market for, our products in certain regions of the world and the ability to terminate the agreement by either party with up to three months notice. Estimated sales returns are based on historical experience and are recorded at the time product revenue is recognized.

In the first quarter of 2006, we signed a distribution agreement with a major U.S. distributor. Revenue from this distributor will be recognized on a resale basis. At September 30, 2006, $0.3 million in deferred revenue was recorded for shipments to this distributor.

Warranty Reserves. We extend a warranty period of one year for all our products. For products sold under our warranty, we will repair the goods, provide replacements at no charge to the customer, or refund amounts to the customer for defective products. Warranty reserves were established beginning August 1, 2005 for the standard warranty period. We record estimated warranty costs at the time we recognize product revenue. These costs are based on historical experience by product over the preceding 12 months. As the complexity of our products increases, we could experience higher warranty claims relative to sales than we have previously experienced, and we may need to increase these estimated warranty reserves.

Inventory Valuation. We value our inventory at the lower of standard cost (which approximates actual cost on a first-in, first-out basis) or its current estimated market value. We write down inventory for obsolescence or lack of demand on assumptions about future demand and market conditions. If actual market conditions are less favorable than those projected by management, additional inventory write-downs may be required.

Accounting for Income Taxes. In accordance with SFAS No. 109, we recognize federal, state and foreign current tax liabilities or assets based on our estimate of taxes payable or refundable in the current fiscal year by tax jurisdiction. We also recognize federal, state and foreign deferred tax assets or liabilities for our estimate of future tax effects attributable to temporary differences and carryforwards. We record a valuation allowance to reduce any deferred tax assets by the amount of any tax benefits that, based on available evidence and judgment, are not expected to be realized.

Our calculation of current and deferred tax assets and liabilities is based on certain estimates and judgments and involves dealing with uncertainties in the application of complex tax laws. Our estimates of current and deferred tax assets and liabilities may change based, in part, on added certainty or finality to an anticipated outcome, changes in accounting or tax laws in the U.S. or foreign jurisdictions where we operate, or changes in other facts or circumstances. In addition, we recognize liabilities for potential U.S. and foreign income tax contingencies based on our estimate of whether, and the extent to which, additional taxes may be due. If we determine that payment of these amounts is unnecessary or if the recorded tax liability is less than our current assessment, we may be required to recognize an income tax benefit or additional income tax expense in our financial statements, accordingly.

We adopted SFAS 123(R) as of January 1, 2006 and, as a result, incurred significant additional stock-based compensation expense, some of which related to incentive stock options for which no corresponding tax benefit is recognized unless a disqualifying disposition occurs. Disqualifying dispositions result in a reduction of income tax expense in the quarter when the disqualifying disposition occurs in an amount equal to the tax benefit relating to previously expensed stock compensation. Tax benefits related to tax deductions in excess of previously expensed stock compensation are recorded as an addition to paid-in-capital.

Contingencies. We are currently engaged in litigation activities that are described in Note 8 to our Condensed Consolidated Financial Statements and in our Form 10-K filed with the Securities and Exchange Commission on March 28, 2006. In addition, from time to time, we may be subject to other contingent liabilities. When this occurs, we will evaluate the appropriate accounting for the potential contingent liabilities using SFAS 5, Accounting for Contingencies, to determine whether a contingent liability should be recorded. In making this determination, we may, depending on the nature of the matter, consult with internal and external legal counsel and technical experts. Based on the facts and circumstances in each matter, we will assess whether it is probable that a contingent loss has occurred and whether the amount of such loss can be estimated. If we determine a loss is probable and estimable, we will record a contingent loss in accordance with SFAS 5. In determining the amount of contingent loss to report, we will take into account the advice received from experts and other factors, including the status of the legal proceedings, settlement negotiations (which may be ongoing) and prior case history, among others. Should the judgments and estimates made by management need to be adjusted as additional information becomes available, we may need to record additional contingent losses that could materially and adversely impact our results of operations or reverse prior contingent loss accruals, which could result in a favorable impact on our results of operations.

Accounting for Stock-Based Compensation. Effective January 1, 2006, we began accounting for stock-based compensation arrangements in accordance with the provisions of SFAS 123(R). Under SFAS 123(R), compensation cost is established by determining the fair value of the option on the date of grant. The compensation cost is then amortized on a straight-line basis over the vesting period. We use the Black Scholes option pricing model to determine the fair value of the stock options at the date of grant. Black Scholes requires us to estimate key assumptions such as expected term, volatility, dividend yield and risk-free interest rate. The estimate of these key assumptions is based on historical information and judgment regarding market factors and trends. If actual results are not consistent with our assumptions and judgment used in estimating the key assumptions, we may be required to increase or decrease compensation expense or income tax expense, which could be material to our results of operations.

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Results of Operations

The table below sets forth the data from our statement of operations as a percentage of revenue for the periods indicated:

	Three months ended September 30,		Nine months ended September 30,	
	2006	2005	2006	2005
Revenue	100.0%	100.0%	100.0%	100.0%
Cost of revenue	34.4%	35.7%	36.4%	36.5%
Gross profit	65.6%	64.3%	63.6%	63.5%
Operating expenses:				
Research and development	21.6%	13.6%	20.9%	16.5%
Selling, general and administrative	25.2%	16.4%	26.7%	19.4%
Patent litigation	21.2%	-15.1%	16.1%	26.1%
Total operating expenses	68.0%	14.9%	63.7%	62.0%
Income (loss) from operations	-2.4%	49.4%	-0.1%	1.5%
Other income (expense):				
Interest and other income	2.4%	1.3%	2.4%	1.6%
Interest and other expense	-0.3%	-0.2%	-0.3%	-0.2%
Total other income, net	2.1%	1.1%	2.1%	1.4%
Income (loss) before income taxes	-0.3%	50.5%	2.0%	2.9%
Income tax provision	6.6%	19.0%	3.6%	1.0%
Net income (loss)	-6.9%	31.5%	-1.6%	1.9%

Revenue. Revenue for the three months ended September 30, 2006 was $27.3 million, a decrease of $2.5 million, or 8.3%, as compared to $29.7 million for the three months ended September 30, 2005. Our DC to DC converter product family increased nominally by $0.3 million, or 1.7%. However, this did not offset the decrease in revenue from our LCD backlight inverter product family which decreased by $2.7 million. Revenue for our LCD backlight inverter products decreased due to customer concerns regarding the O2 Micro litigation and the availability of alternative solutions from parties not involved in the litigation.

Revenue for the nine months ended September 30, 2006 was $78.6 million, an increase of $12.0 million, or 18.0%, over $66.6 million for the nine months ended September 30, 2005. During this same period, revenue from our DC to DC converter product family increased by $15.5 million, or 39.7%. Sales of the DC to DC converter products remained strong due to an increase in the demand for our new and existing products in the consumer electronic communications markets. Revenue from our LCD backlight inverter product family decreased by $3.5 million, or 13.9% due to a decrease in demand primarily related to customer concerns regarding the O2 Micro litigation and the availability of alternative solutions from parties not involved in the litigation.

The following table illustrates changes in our revenue by product family:

	For the three months ended September 30,					For the nine months ended September 30,				
	2006		2005			2006		2005		
	(in thousands) Amount	% of Revenue	(in thousands) Amount	% of Revenue	Change	(in thousands) Amount	% of Revenue	(in thousands) Amount	% of Revenue	Change
DC to DC Converters	$ 18,820	69.1%	$ 18,501	62.3%	1.7%	$ 54,453	69.3%	$ 38,970	58.5%	39.7%
	7,425	27.2%	10,140	34.1%	-26.8%	21,809	27.7%	25,321	38.0%	-13.9%

LCD Backlight Inverters										
Audio Amplifiers	1,010	3.7%	1,065	3.6%	-5.2%	2,357	3.0%	2,309	3.5%	2.1%
	$ 27,255	100.0%	$ 29,706	100.0%	-8.3%	$ 78,619	100.0%	$ 66,600	100.0%	18.0%

Gross Profit. Gross profit as a percentage of revenue was 65.6% for the three months ended September 30, 2006 as compared to 64.3% for the same period in 2005. The increase was due primarily to a change in product mix and efficiencies in test costs resulting from the start-up of our Chengdu operations in 2006. For the nine months ended September 30, 2006 and 2005, gross profit was approximately 64%.

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Research and Development.

	For the three months ended September 30,			For the nine months ended September 30,		
	2006	2005		2006	2005	
	(in thousands)		Change	(in thousands)		Change
Revenue	$ 27,255	$ 29,706	-8.3%	$ 78,619	$ 66,600	18.0%
Research and development (R&D) (including stock-based compensation of $1,330 and $4,039 for the three and nine months ended September 30, 2006 and $569 and $2,045 for the three and nine months ended September 30, 2005, respectively)	5,897	4,045	45.8%	16,391	10,980	49.3%
R&D as a percentage of revenue	21.6%	13.6%		20.8%	16.5%	

Research and development expenses were $5.9 million, or 21.6% of revenue, for the three months ended September 30, 2006 and $4.0 million, or 13.6% of revenue, for the three months ended September 30, 2005. This increase was due to costs associated with an increase in design engineering personnel as well as new product development activities both in the U.S. and Asia. R&D expenses also increased due to additional stock compensation expenses related to the adoption of SFAS 123(R) effective January 1, 2006. See Note 2 Stock Based Compensation of Notes to the Condensed Consolidated Financial Statements for information regarding the adoption of SFAS 123(R).

R&D expenses were $16.4 million, or 20.8% of revenue, for the nine months ended September 30, 2006 and $11.0 million, or 16.5% of revenue, for the nine months ended September 30, 2005. This increase was due to costs associated with an increase in design engineering personnel as well as new product development activities both in the U.S. and Asia. We also completed the start up phase of our design center in China and initiated start-up activities for several design centers outside of California. R&D expenses also increased due to additional stock compensation expenses related to the adoption of SFAS 123(R) effective January 1, 2006. See Note 2 Stock Based Compensation of Notes to the Condensed Consolidated Financial Statements for information regarding the adoption of SFAS 123(R).

Selling, General and Administrative.

	For the three months ended September 30,			For the nine months ended September 30,		
	2006	2005		2006	2005	
	(in thousands)		Change	(in thousands)		Change
Revenue	$ 27,255	$ 29,706	-8.3%	$ 78,619	$ 66,600	18.0%
Selling, general and administrative (SG&A) (including stock-based compensation of $1,518 and $4,293 for the three and nine months ended September 30, 2006 and $450 and $1,733 for the three and nine months ended September 30, 2005, respectively)	6,877	4,880	40.9%	21,003	12,963	62.0%
SG&A as a percentage of revenue	25.2%	16.4%		26.7%	19.5%	

Selling, general and administrative expenses were $6.9 million, or 25.2% of revenue, for the three months ended September 30, 2006, and $4.9 million, or 16.4% of revenue, for the three months ended September 30, 2005. SG&A expenses increased to strengthen the sales, distribution and finance infrastructure. SG&A expenses also increased due to additional stock compensation expenses related to the adoption of SFAS 123(R) effective January 1, 2006. See Note 2 Stock Based Compensation of Notes to the Condensed Consolidated Financial Statements for information regarding the adoption of SFAS 123(R).

SG&A expenses were $21.0 million, or 26.7% of revenue, for the nine months ended September 30, 2006, and $13.0 million, or 19.5% of revenue, for the nine months ended September 30, 2005. SG&A expenses increased to strengthen the sales, distribution and finance infrastructure and increased advertising expenses. SG&A also increased due to an increase in professional fees, primarily for audit, tax and accounting services and activities related to Sarbanes-Oxley compliance, the implementation of SFAS 123(R) and the restatement of prior SEC filings. See Note 2 Stock Based Compensation of Notes to the Condensed Consolidated Financial Statements for information regarding the

adoption of SFAS 123(R).

Patent Litigation.

	For the three months ended September 30,			For the nine months ended September 30,		
	2006	2005		2006	2005	
	(in thousands)		Change	(in thousands)		
Revenue	$ 27,255	$ 29,706	-8.3%	$ 78,619	$ 66,600	18.0%
Patent litigation	5,765	(4,488)	-228.5%	12,650	17,382	-27.2%
Patent litigation as a percentage of revenue	21.2%	-15.1%		16.1%	26.1%	

Patent litigation expenses were $5.8 million, or 21.2% of revenue, for the three months ended September 30, 2006. This included a $3.0 million settlement with Micrel that was recorded in September 2006. For the three months ended September 30, 2005, we had a patent litigation credit of $4.5 million due to the reversal of $8.8 million of a $12.0 million patent litigation provision in the third quarter of 2005. For the nine months ended September 30, 2006 and 2005, patent litigation expenses were $12.7 million, or 16.1% of revenue and $17.4 million, or 26.1% of revenue, respectively. This included a $3.0 million settlement with Micrel and $3.3 million in provision for legal expenses in 2006 and 2005, respectively. The decrease in patent litigation expenses was due to the settlement of certain lawsuits in 2005 and 2006 and a corresponding reduction in legal costs for those cases. For a more complete description of our litigation matters, please see Note 8 Litigation of Notes to the Condensed Consolidated Financial Statements, Part I, Item 3 of our Form 10-K filed with the SEC on March 28, 2006 and Part II, Item 1 of our Form 10-Q filed with the SEC on August 4, 2006.

Income Tax Provision. The provision for income taxes was calculated based on the Company s estimate of its effective tax rate for the full year. At September 30, 2006, the Company s estimate of its effective tax rate for the year ending December 31, 2006 was approximately 81%, but the inclusion of the tax effects of one-time litigation settlements yields a year-to-date calculated tax provision of 175% or $2.8 million. The estimated effective tax rate increased from the second quarter estimated tax rate of 66% because of an increase in stock-based compensation expense, which is not tax deductible, a change in future estimated taxable income and other elements associated with the implementation of the Company s international tax structure.

Liquidity and Capital Resources.

As of September 30, 2006, we had working capital of $75.0 million, including cash and cash equivalents of $30.5 million, investments of $39.7 million and current restricted assets of $3.9 million. This compares to working capital of $65.5 million, including cash and cash equivalents of $25.1 million, investments of $38.8 million and current restricted assets of $2.9 million as of December 31, 2005. Net cash provided by operating activities was $7.7 million for the nine months ended September 30, 2006 and $11.7 million for the nine months ended September 30, 2005. Net cash used in investing activities was $8.1 million in the nine months ended September 30, 2006 and $0.2 million in the nine months ended September 30, 2005. In the nine months ended September 30, 2006, we purchased $6.3 million in capital assets, of which $3.8 million was for our Chengdu, China facility and $1.3 million was used to renovate our future San Jose headquarters.

We use professional investment management firms to manage the majority of our invested cash. External investment firms managed 82.2% of our cash and investment balances for the nine months ended September 30, 2006. All investments are made according to guidelines and policies approved by the Board of Directors. Net cash provided by financing activities for the nine months ended September 30, 2006 and 2005 was $5.7 million and $1.3 million, respectively. The increase in net cash provided by financing activities for the nine months ended September 30, 2006 was primarily due to the adoption of FAS 123(R), which requires excess tax benefits to be reported as a financing cash flow item and $3.0 million in proceeds from the issuance of common stock.

We believe that cash generated from operations, together with the liquidity provided by existing cash balances and short term investments, will be sufficient to satisfy our liquidity requirements for the next 12 months. For further details regarding our operating, investing and financing activities, see our Condensed Consolidated Statement of Cash Flows.

Contractual Obligation and Off Balance Sheet Arrangements.

We lease our current headquarters and sales offices in Los Gatos under non-cancelable operating leases which expire at various dates through 2010. Certain of our facility leases provide for periodic rent increases. In addition, we entered into lease arrangements in 2004 for our facilities located in Chengdu, Shanghai and Shenzhen, China. On June 13, 2006, we entered into a noncancelable sublease agreement with FedEx Freight West, Inc. and Brokaw Interests, for approximately 55,110 square feet of office space located at 6409 Guadalupe Mines Road, San Jose, California, the site of our future U.S. headquarters. Beginning on September 15, 2006 and subject to any rent credit to which we are entitled under the construction rider, we are obligated to make monthly rent payments for the premises through October 31, 2009. Upon moving into our San Jose facility, we will commence activities to sub-lease our current facility in Los Gatos. Total obligations under these leases are included in the table below.

We outsource the production of wafers to a third party foundry. The agreement with the foundry provides for non-binding rolling six-month production forecasts. Additionally, we purchase assembly services primarily from two contractors in Asia. As of September 30, 2006, our total outstanding purchase commitments were $7.3 million.

As of September 30, 2006, we had no off-balance sheet financing arrangements or activities outside of operating leases and purchase orders other than those discussed above. The following table summarizes our contractual obligations at September 30, 2006, and the effect such obligations are expected to have on liquidity and cash flow over the next five years (in thousands):

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	Payments by Period				
	Total	Less than 1 year	1-3 years	4-5 years	Thereafter
Operating leases	$ 4,502	$ 657	$ 3,743	$ 102	$
Outstanding purchase commitments	7,262	7,262			
Payments under settlement agreement	2,000		2,000		
	$ 13,764	$ 7,919	$ 5,743	$ 102	$

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

For a discussion of market risks at December 31, 2005, refer to Item 7A, Quantitative and Qualitative Disclosures about Market Risk in our annual report on Form 10-K for the fiscal year ended December 31, 2005. During the three and nine months ended September 30, 2006, there were no material changes or developments that would materially alter the market risk assessment performed as of December 31, 2005.

ITEM 4. CONTROLS AND PROCEDURES

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our reports that we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission s rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

In connection with the filing of this quarterly report on Form 10-Q, our Chief Executive Officer and Chief Financial Officer, with the participation of management, evaluated the effectiveness of our disclosure controls and procedures as of the end of the period covered by this quarterly report on Form 10-Q, and concluded that due to the material weaknesses described below, we did not have effective disclosure controls and procedures as of the end of the period covered by this quarterly report on Form 10-Q.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. The following material weaknesses have been identified:

- A material weakness in the design and operating effectiveness of controls over the accuracy and disclosure of stock-based employee compensation expense in conformity with generally accepted accounting principles. Specifically, we did not maintain effective controls over the following:

  - the completeness and accuracy of the accounting for option cancellations and

  - the accuracy of the recording of stock-based compensation.

These control deficiencies led to a misstatement of stock-based compensation expense that resulted in a material misstatement to the financial statements in prior periods which was not prevented or detected.

- A material weakness in the design and operating effectiveness of controls over the accounting for income taxes, including the calculation of the income tax provision and related deferred tax assets and liabilities. This control deficiency led to a misstatement of the deferred tax asset and related tax provision that resulted in a material misstatement to the financial statements in prior periods which was not prevented or detected.

- A material weakness in the operating effectiveness of controls over the financial close, budgeting and reporting process. Specifically, we did not maintain effective controls over the following:

- completing a reconciliation for all key accounts each month, and

- completing a detailed review of the actual results versus the budgeted results for each period.

- A material weakness in the operating effectiveness of controls over allocation of expenses to the appropriate accounting period.

- A material weakness in the control environment due to an insufficient number of qualified resources with required proficiency to apply our accounting policies.

These material weaknesses were previously reported in our 2005 Form 10-K filed with the SEC on March 28, 2006. We have not yet completed the remediation efforts required to address these material weaknesses. However, we have outlined a remediation plan that addresses the control deficiencies and material weaknesses.

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Changes in internal control over financial reporting. There was no change in our system of internal control over financial reporting during the three months ended September 30, 2006 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting. During the nine months ended September 30, 2006, project teams have been identified and are currently in the process of remediating specific areas of concern. We also strengthened our finance team in the areas of financial planning and analysis, tax and external reporting.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

Micrel Corporation

Micrel filed an action in November 2004 in the United States District Court for the Northern District of California for alleged patent infringement, misappropriation of trade secrets, common law misappropriation, and unfair competition against the Company and for alleged misappropriation of trade secrets, common law misappropriation , breach of confidentiality agreements and unfair competition against Michael Hsing, the Company s CEO, and Jim Moyer, the Company s chief design engineer, both of whom are former Micrel employees. On September 21, 2006, the Company reached a settlement of the patent infringement and trade secret misappropriation lawsuit brought by Micrel. In the settlement, the parties agreed to dismiss all claims and counterclaims in the litigation with prejudice, and Micrel agreed to license to MPS, and not to assert the patents-in-suit against the Company or its customers in the future. Micrel also agreed to release Michael Hsing, the Company s chief executive officer, and Jim Moyer, the Company s chief design engineer, from all claims for any alleged trade secret claims based on any confidential information. In return, the Company agreed to pay Micrel $3 million in three equal installments in each of 2006, 2007 and 2008, of which $1 million was paid in September 2006. The $3 million settlement was charged to patent litigation expense in the three months ended September 30, 2006.

O2 Micro, Inc.

On October 11, 2006, O2 Micro stipulated to dismiss its claim that that certain of the Company s CCFL products infringe O2 s 129 patent. The dismissal is with prejudice to O2 Micro reasserting O2 s 129 patent against the Company and its CEO, Michael Hsing, and other named defendants as to those products identified in the case pending in the United States District Court for the Northern District of California. Specifically, O2 Micro covenanted not to assert or reassert O2 s 129 patent against the named defendants for infringement by the Company s certain full bridge inverter controllers. The Court has issued an order to grant the dismissal. The trial date for O2 s 722 patent infringement against the Company is set to begin on April 30, 2007.

During 2003 and 2004, two Taiwan courts granted three provisional seizures against the Company which would entitle O2 to seize up to approximately $1.9 million of the Company s assets in Taiwan. In October 2006, O2 requested that the court seize the Company s bank account with approximately $0.4 million cash in the account. The Company is in the process of posting a bond in the amount of $1.8 million to have our assets released and to avoid further seizures until the matter with O2 is resolved.

For a complete description of our legal proceedings, please see Note 8 Litigation of Notes to the Condensed Consolidated Financial Statements, and Part I, Item 3 of our Form 10-K filed with the SEC on March 28, 2006 and Note 8 Litigation of Notes to the Condensed Consolidated Financial Statements and Part II, Item 1 of our Form 10-Q filed with the SEC on August 4, 2006, which are incorporated herein by reference.

ITEM 1A. RISK FACTORS

Our business involves risks and uncertainties. You should carefully consider the risks described below, together with all of the other information in this Form 10-Q and other filings with the Securities and Exchange Commission in evaluating our business. If any of the following risks actually occur, our business, financial condition, operating results and growth prospects would likely be adversely affected. In such an event, the trading price of our common stock could decline, and you could lose all or part of your investment in our common stock. Our past financial performance should not be considered to be a reliable indicator of future performance, and investors should not use historical trends to anticipate results or trends in future periods. These risks involve forward-looking statements and our actual results may differ substantially from those discussed in these forward-looking statements.

If we are unsuccessful in any of the legal proceedings between us and O2 Micro, Linear Technology or Taiwan Sumida Electronics, we could be prevented from selling many of our products and/or be required to pay substantial damages or fines. An unfavorable outcome or an additional award of damages, attorneys fees or an injunction could cause our revenue to decline significantly and could severely harm our business and operating results.

We are engaged in legal proceedings with O2 Micro and Linear Technology. These proceedings involve various claims and counterclaims in the United States and Taiwan alleging, among other things, patent and trade secret infringement, misappropriation of trade secrets and unfair competition. O2 Micro has also taken legal action against our wafer manufacturer and various customers and users of our products in Taiwan and the United States, some of which we are indemnifying. See Note 8 Litigation of Notes to the Condensed Consolidated Financial Statements, Part II, Item 1 of our Form 10-Q filed with the SEC on August 4, 2006 and Part 1, Item 3, of our Form 10-K filed with the SEC on March 28, 2006, for a description of each of these proceedings.

If we or our customers are not ultimately successful in any of these litigations or other litigations that could be brought against us, or if any of the decisions in our favor are reversed on appeal, we could be ordered to pay monetary fines and/or damages. If we are found liable for willful patent infringement or trade secret misappropriation, damages could be doubled or tripled. We and/or our customers could also be prevented from selling some or all of our products, either into Taiwan or in the U.S. Moreover, our customers and end-users could decide not to use our products, our wafer manufacturer could decide to reduce or eliminate its manufacturing of some of our products, or our products or our customers accounts payable to us could be seized in Taiwan. Finally, interim developments in these proceedings could increase the volatility in our stock price as the market assesses the impact of such developments on the likelihood that we will or will not ultimately prevail in these proceedings.

We are also engaged in a legal proceeding with Taiwan Sumida Electronics Inc. (TSE). In November 2005, a jury found that TSE infringed one of O2 Micro s patents. The products that were the subject of the litigation contained some of our products. In August 2005, we terminated an indemnity agreement we had previously entered with TSE and sued TSE for material breach of the agreement. In January 2006, TSE filed a counterclaim against us for breach of the indemnification agreement and related claims. If we do not ultimately prevail on our contention that TSE materially breached our agreement, we could be required to pay TSE damages, including any damages awarded against TSE in favor of O2 Micro as well as any attorneys fees and costs resulting from these lawsuits.

Given our inability to control the timing and nature of significant events in our legal proceedings, our legal expenses are difficult to forecast and may vary substantially from our publicly-disclosed forecasts with respect to any given quarter, which could contribute to increased volatility in our stock price and business.

Until our legal proceedings with O2 Micro, TSE and Linear Technology are resolved, we will continue to incur significant legal expenses that vary with the level of activity in each of these proceedings. This level of activity is not entirely within our control as we may need to respond to legal actions by the opposing parties or scheduling decisions by the judges. Consequently, it is difficult for us to forecast our legal expenses for any given quarter, which adversely affects our ability to forecast our expected results of operations in general. If we fail to meet the expectations of securities or industry analysts as a result of unexpected increases in our legal expenses, our stock price could decline.

Our ongoing legal proceedings and the potential for additional legal proceedings have diverted financial and management resources.

The semiconductor industry is characterized by frequent claims of infringement and litigation regarding patent and other intellectual property rights, such as our litigation matters with O2 and Linear Technology. Patent infringement is an ongoing risk, in part because other companies in our industry could have patent rights that may not be identifiable when we initiate development efforts. Litigation may be necessary to enforce our intellectual property rights, and we may have to defend ourselves against additional infringement claims. Such litigation is very costly. In the event any third party makes a new infringement claim against us or our customers, we could incur additional ongoing legal expenses. Our management team may also be required to devote a great deal of time, effort and energy to these legal proceedings, which could adversely affect our business.

We have a history of losses, and we may not sustain profitability on a quarterly or annual basis.

Fiscal year ended December 31, 2005 was our first profitable year of operations. From inception to fiscal year ended December 31, 2004, we incurred losses on an annual basis. For the three and nine months ended September 30, 2006, our net loss was $1.9 million and $1.2 million, respectively. As of September 30, 2006, we had an accumulated deficit of $16.3 million. We expect to incur significant operating expenses over the next several years in connection with the continued development and expansion of our business. Our operating expenses include general and administrative expenses, selling and

marketing expenses, litigation expenses, stock-based compensation expenses and research and development expenses relating to products that will not be introduced and will not generate revenue until later periods, if at all. In addition, we expect to continue to incur significant legal expenses in connection with the litigations in which we are involved. We may not achieve or sustain profitability on a quarterly or annual basis in the future.

We do not expect to sustain our recent growth rate.

We have in the past experienced significant revenue growth in a relatively short period of time due primarily to increased sales of our DC to DC converter and LCD backlight inverter product families. Our annual revenue increased from $12.2 million in 2002 to $24.2 million in 2003 to $47.6 million in 2004 to $99.1 million in 2005, a compound annual growth rate of 101%. We are currently experiencing some slowing in our revenue growth across all of our product lines. We do not expect growth rates comparable to past periods in future periods for our CCFL backlight products due to increased competition and ongoing litigation between O2 Micro and other competitors and end-customers which resulted in customer concerns and lost revenue and order opportunities. In addition, we are experiencing increased price competition in some segments of our DC to DC converter products as well as longer than expected new product acceptance by our customers, and we do not expect growth rates comparable to past periods.

Due to our limited operating history and the nature of our business as a component supplier, we may have difficulty both in accurately predicting our future revenue and appropriately budgeting our expenses.

We were incorporated in 1997 and did not generate significant revenue until 2000. Because of our limited operating experience, the rapidly evolving nature of the markets into which we sell our products and other factors beyond our control, we may have difficulty accurately forecasting our revenue and expenses. Since we provide components for end products and systems, demand for our products is influenced by our customers end product demand. Our revenue depends on the timing, size, and speed of commercial introductions of end products and systems that incorporate our products, all of which are inherently difficult to forecast, as well as the ongoing demand for previously introduced end products and systems. In addition, demand for our products is influenced by our customers ability to manage their inventory. Our sales to distributors are subject to higher volatility because they service demand from multiple levels of the supply chain which is difficult to forecast accurately. If our customers, including distributors, do not manage their inventory correctly or misjudge their customers demand, our shipments to and orders from our customers may vary significantly on a quarterly basis.

Finally, a significant percentage of our revenue in each quarter is dependent on sales that are booked and shipped in the same quarter. This is referred to as our turns business. Due to increased dependence on our turns business and the fact that we typically do not enter into long-term agreements with our customers or require them to provide us with quarterly forecasts, it is difficult for us to accurately forecast our revenue for any given quarter.

We expect our operating results to fluctuate from quarter to quarter and year to year, which may make it difficult to predict our future performance and could cause our stock price to decline.

Our revenue, expenses, and results of operations are difficult to predict, have varied significantly in the past and will continue to fluctuate significantly in the future due to a number of factors, many of which are beyond our control. We expect fluctuations to continue for a number of reasons, including:

- the timing of developments and related expenses in our litigation matters with O2, TSE and Linear Technology and any future litigation;
- the possibility of additional lost business as a result of customer and prospective customer concerns about adverse outcomes in our litigations or about being litigation targets;
- continued dependence on our turns business (orders received and shipped within the same fiscal quarter);
- the timing of new product introductions by us and our competitors;

the acceptance of our new products in the marketplace;

our ability to develop new process technologies and achieve volume production;

the scheduling, rescheduling, or cancellation of orders by our customers;

the cyclical nature of demand for our customers products;

inventory levels and product obsolescence;

seasonality and variability in the computer, consumer electronics, and wireless markets;

the availability of adequate manufacturing capacity from our outside suppliers;

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- changes in manufacturing yields;

- general economic conditions in the countries where our products are sold or used; and

- movements in exchange rates, interest rates or tax rates.

Due to the factors noted above and other risks described in this section, many of which are beyond our control, you should not rely on quarter-to-quarter or year-over-year comparisons to predict our future financial performance. Unfavorable changes in any of the above factors may seriously harm our business and cause our stock price to decline.

The highly cyclical nature of the semiconductor industry, which has produced significant and sometimes prolonged downturns, could materially adversely affect our operating results, financial condition and cash flows.

Historically, the semiconductor industry has been highly cyclical and, at various times, has experienced significant downturns and wide fluctuations in supply and demand. These conditions have caused significant variances in product demand and production capacity, as well as rapid erosion of average selling prices. The industry may experience severe or prolonged downturns in the future, which could result in downward pressure on the price of our products as well as lower demand for our products. Because significant portions of our expenses are fixed in the short term or incurred in advance of anticipated sales, we may not be able to decrease our expenses in a timely manner to offset any sales shortfall. These conditions could have a material adverse affect on our operating results, financial condition and cash flows.

If demand for our products declines in the major end markets that we serve, our revenue will decrease.

We believe that the application of our products in the computer, consumer electronics, networking and wireless markets will continue to account for the majority of our revenue. If the demand for our products declines in the major end markets that we serve, our revenue will decrease. For example, as technology evolves, the ability to integrate the functionalities of various components, including our discrete semiconductor products, onto a single chip and/or onto other components of systems containing our products increases. Should our customers require integrated solutions that we do not offer, demand for our products could decrease, and our business and results of operations could be adversely affected.

Moreover, approximately one quarter of our business is based on products that are used in systems that contain cold cathode fluorescent lighting (CCFL). CCFL tubes contain mercury, which is the subject of environmental concerns, particularly in Europe. Should environmental issues impair the widespread use of our CCFL-based products, and should we be unable to produce replacement products based on LED lighting fast enough to compensate for the loss of our CCFL-related business, our business and results of operations could be adversely affected.

We receive a significant portion of our revenue from a small number of customers, and the loss of any one of these customers or failure to collect a receivable from them could adversely affect our operations and financial position.

We market our products through distribution arrangements and through our direct sales and applications support organization to customers that include original equipment manufacturers, original design manufacturers, and electronic manufacturing service providers. Receivables from our customers are not secured by any type of collateral and are subject to the risk of being uncollectible. Significant deterioration in the liquidity or financial condition of any of our major customers or any group of our customers could have a material adverse impact on the collectibility of our accounts receivable and our future operating results. We primarily conduct our sales on a purchase order basis, and we do not have any long-term supply contracts.

Moreover, we believe a high percentage of our products are eventually sold to a number of original equipment manufacturers, or OEMs. Although we communicate with OEMs in an attempt to achieve design wins, which are decisions by OEMs and/or original design manufacturers to incorporate our products, we do not have purchase commitments from these end users. Therefore, there can be no assurance that the OEMs and/or original design manufacturers will continue to incorporate our ICs into their products. OEM technical specifications and requirements can change rapidly, and we may not have products that fit new specifications from an end-customer for whom we have had previous design wins. We cannot be certain that we will continue to achieve design wins from large OEMs, that our direct customers will continue to be successful in selling to the OEMs, or that the OEMs will be successful in selling products which incorporate our ICs. The loss of any significant customer, any material reduction in orders by any of our significant customers or by their OEM customers, the cancellation of a significant customer order, or the cancellation or delay of a customer s or OEM s significant program or product could reduce our revenue and adversely affect our operations and financial condition.

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We purchase inventory in advance based on expected demand for our products, and if demand is not as expected, we may have insufficient or excess inventory, which could adversely impact our financial position.

As a fabless semiconductor company, we purchase our inventory from a third party manufacturer in advance of selling our product. We place orders with our manufacturer based on existing and expected orders from our customers for particular products. While our contracts with our customers and distributors include lead time requirements and cancellation penalties that are designed to protect us from misalignment between customer orders and inventory levels, we must nonetheless make some predictions when we place orders with our manufacturer. In the event that our predictions are inaccurate due to unexpected increases in orders or unavailability of product within the time frame that is required, we may have insufficient inventory to meet our customer demand, which could have an adverse impact on our business and financial position. In the event that we order products that we are unable to sell due to a decrease in orders, unexpected order cancellations or product returns, we may have excess inventory which, if not sold, may need to be scrapped.

We are a small public company. If we fail to make continued improvements to our internal systems and staffing, particularly in the accounting and finance area, and to manage the related expenses, our business may suffer.

As a small public company, we experienced a significant strain on our management, operational and financial resources and systems that has, among other things, adversely affected our internal control over financial reporting. We recently restated our financial statements for certain prior periods and also reported that our internal control over financial reporting was not effective as a result of certain material weaknesses described in Item 4 of Part I of this quarterly report. The accounting errors that resulted in our recent restatements were due, in part, to insufficient resources in our finance department. In recent quarters, we significantly increased the quantity and quality of our permanent financial staff. However, if we fail to continue to adequately staff our accounting and finance function with permanent personnel and maintain internal controls that meet the demands of our business, our ability to operate effectively will suffer. Because of the limited number of personnel in our finance department, the operation of our business depends upon our ability to retain these employees while we continue to improve controls and add additional personnel. These employees hold a significant amount of institutional knowledge about the Company, and, if they were to terminate their employment, our internal control over financial reporting could be adversely affected.

We have a complex international tax structure which could lead to unfavorable adjustments by the Internal Revenue Service or other tax authorities and which could impact our tax estimates.

We have a complex international tax structure. Our calculation of current and deferred tax assets and liabilities is based on certain estimates and judgments and involves dealing with uncertainties in the application of complex tax laws. Our estimates of current and deferred tax assets and liabilities may change based, in part, on added certainty or finality regarding an anticipated outcome, changes in accounting or tax laws in the United States or foreign jurisdictions where we operate, or changes in other facts or circumstances. In addition, we recognize liabilities for potential U.S. and foreign income tax contingencies based on our estimate of whether, and the extent to which, additional taxes may be due. If we determine that payment of these amounts is unnecessary or if the recorded tax liability is less than our current assessment, we may be required to recognize an income tax benefit or additional income tax expense in our financial statements. Such an adjustment could have a material impact on our financial condition and results of operations. In addition, the Company is still maturing in its operations and as such is subject to significant swings in business outlooks that can have a material impact on income tax estimates.

We face risks in connection with the material weaknesses in our internal control over financial reporting and any related remedial measures that we undertake.

In accordance with Section 404 of the Sarbanes-Oxley Act, we included in our 2005 annual report on Form 10-K a management report regarding the effectiveness of our internal control over financial reporting as such term is defined in Rule 13a-15(e) and Rule 15d-15(e) under the Securities Exchange Act of 1934. In preparation for issuing this management report, we documented, evaluated and tested our internal control over financial reporting.

As a result of various accounting errors, we recently restated our annual report on Form 10-K for the year ended December 31, 2004 and quarterly reports on Form 10-Q for the first and second quarters of 2005. In conjunction with these restatements and our assessment of the effectiveness of our internal control over financial reporting, we identified a number of material weaknesses that are described in Item 4 of Part I of this quarterly report.

As of the date of this report, we have not remediated any of these material weaknesses. We cannot be certain that the measures we have already taken and are planning to take to remediate the material weaknesses will sufficiently and satisfactorily address these identified material weaknesses. Furthermore, we cannot be certain that we will not discover additional material weaknesses in the future. If we are unable to assert that our internal control over financial reporting is effective in any future period, or we continue to experience material weaknesses in our

internal control over financial reporting, we could lose investor confidence in the accuracy and completeness of our financial reports, which may have an adverse effect on our stock price and potentially subject us to litigation.

The loss of any of our key personnel or the failure to attract or retain specialized technical and management personnel could impair our ability to grow our business.

Our future success depends upon our ability to attract and retain highly qualified technical and managerial personnel. We are particularly dependent on the continued services of our key executives, including Michael Hsing, our President and Chief Executive Officer, who founded our company and developed our proprietary process technology. In addition, personnel with highly skilled analog and mixed-signal design engineering expertise are scarce and competition for personnel with these skills is intense. There can be no assurance that we will be able to retain existing key employees or that we will be successful in attracting, integrating or retaining other highly qualified personnel with critical capabilities in the future. If we are unable to retain the services of existing key employees or are unsuccessful in attracting new highly qualified employees quickly enough to meet the demands or our business, including design cycles, our business could be harmed.

We currently depend on one third-party supplier to provide us with wafers for our products. If our wafer supplier fails to provide us sufficient wafers at acceptable yields and at anticipated costs, our revenue and gross margin may decline.

We have a supply arrangement with ASMC for the production of wafers. Although certain aspects of our relationship with ASMC are contractual, many important aspects of this relationship depend on ASMC s continued cooperation and our management relationships. O2 sued ASMC in two cases for patent infringement because ASMC manufactures our products. It is possible that our relationship with ASMC could be materially and adversely affected by the O2 litigation. In addition, the fabrication of ICs is a highly complex and precise process. Problems in the fabrication process can cause a substantial percentage of wafers to be rejected or numerous ICs on each wafer to be non-functional. This could potentially reduce the yields. The failure of ASMC to supply us wafers at acceptable yields could prevent us from fulfilling our customer orders for our products and would likely cause a decline in our revenue.

Although we provide ASMC with rolling forecasts of our production requirements, ASMC s ability to provide wafers to us is limited by the available capacity, particularly capacity in the geometries we require, at the facilities in which it manufactures wafers for us. An increased need for capacity to meet internal demands or demands of other customers could cause ASMC to reduce capacity available to us. ASMC may also require us to pay amounts in excess of contracted or anticipated amounts for wafer deliveries or require us to make other concessions in order to acquire the wafer supply necessary to meet our customer requirements. If ASMC extends lead times, limits supplies or the types of capacity we require, or increases prices due to capacity constraints or other factors, our revenue and gross margin may decline.

Further, as is common in the semiconductor industry, our customers may reschedule or cancel orders on relatively short notice. Under our agreement with ASMC, we have an option to order wafers based on a committed forecast that can cover a period of one to six months. If our customers cancel orders after we submit a committed forecast to ASMC for the corresponding wafers, we may be required to purchase wafers that we may not be able to resell, which would adversely affect our operating results, financial condition, and cash flows.

We might not be able to deliver our products on a timely basis if our relationships with our assembly and test subcontractors are disrupted or terminated.

All of our products are assembled by third-party subcontractors and a significant percentage of our testing is currently performed by third-party subcontractors. We do not have any long-term agreements with these subcontractors. As a result, we may not have direct control over product delivery schedules or product quality. Also, due to the amount of time typically required to qualify assembly and test subcontractors, we could experience delays in the shipment of our products if we were forced to find alternate third parties to assemble or test our products. Any future product delivery delays or disruptions in our relationships with our subcontractors could have a material adverse effect on our operating results, financial condition, and cash flows.

Failure to protect our proprietary technologies or maintain the right to certain technologies may negatively affect our ability to compete.

We rely heavily on our proprietary technologies. Our future success and competitive position depend in part upon our ability to obtain and maintain protection of certain proprietary technologies used in our products. We pursue patents for some of our new products and unique technologies, and we also rely on a combination of nondisclosure agreements and other contractual provisions, as well as our employees commitment to confidentiality and loyalty, to protect our technology, know-how, and processes. Despite the precautions we take, it may be possible for unauthorized third parties to copy aspects of our current or future technology or products or to obtain and use information that we regard as proprietary. Moreover, in our trial in Oakland, California against O2 last year, the jury returned a verdict holding that a number of the claims of two of our patents covering elements of our CCFL technology are invalid. We intend to continue to protect our proprietary technology,

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including through patents. However, there can be no assurance that the steps we take will be adequate to protect our proprietary rights, that our patent applications will lead to issued patents, that others will not develop or patent similar or superior products or technologies, or that our patents will not be challenged, invalidated, or circumvented by others. Furthermore, the laws of the countries in which our products are or may be developed, manufactured, or sold may not protect our products and intellectual property rights to the same extent as laws in the United States. Our failure to adequately protect our proprietary technologies could harm our business.

We derive a substantial majority of our revenue from direct or indirect sales to customers in Asia and have significant operations in Asia, which may expose us to political, regulatory, economic, foreign exchange, and operational risks.

We derive a substantial majority of our revenue from customers located in Asia through direct or indirect sales through distribution arrangements with parties located in Asia. As a result, we are subject to increased risks due to this geographic concentration of business and operations. In 2005, approximately 95% of our revenue was from customers in Asia. For the three and nine months ended September 30, 2006, approximately 84% and 87% of our revenue, respectively, was from customers located in Asia. There are risks inherent in doing business internationally, including:

- changes in, or impositions of, legislative or regulatory requirements, including tax laws in the United States and in the countries in which we manufacture or sell our products;
- trade restrictions, including restrictions imposed by the United States government on trading with parties in foreign countries;
- transportation delays;
- international political relationships and threats of war;
- terrorism and threats of terrorism;
- epidemics and illnesses;
- work stoppages;
- economic and political instability;
- changes in import/export regulations, tariffs, and freight rates;
- longer accounts receivable collection cycles and difficulties in collecting accounts receivables;
- enforcing contracts generally;
- currency exchange rate fluctuations impacting intra-company transactions; and

less effective protection of intellectual property and contractual arrangements.

Devaluation of the U.S. Dollar relative to other foreign currencies, including the Chinese Yuan, may adversely affect results of operations.

Our manufacturing and packaging suppliers are and will be substantially located in China. Should the value of the Chinese Yuan continue to rise against the U.S. Dollar, there could be an increase in our manufacturing costs relative to competitors who have manufacturing facilities located in the U.S., which could adversely affect our operations. In addition, because we collect payments from all customers in U.S. dollars, fluctuations in the value of foreign currencies could have an adverse impact on our customers business, which could negatively impact our business and results of operations.

We and our manufacturing partners are or will be subject to extensive Chinese government regulation, and may receive the benefit of various incentives from Chinese governments that include conditions or may be reduced or eliminated, any of which could increase our costs or limit our ability to sell products and conduct activities in China.

Most of our manufacturing partners, including ASMC, our current foundry, are located in China. In addition, we have established a facility in China, initially for the testing of our ICs. The Chinese government has broad discretion and authority to regulate the technology industry in China. China s government has implemented policies from time to time to regulate economic expansion in China. It also exercises significant control over China s economic growth through the allocation of resources, controlling payment of foreign currency-denominated obligations, setting monetary policy and providing preferential treatment to particular industries or companies. New regulations or the readjustment of previously implemented regulations could require us and our manufacturing partners to change our business plans, increase our costs, or limit our ability to sell products and conduct activities in China, which could adversely affect our business and operating results.

In addition, the Chinese government and provincial and local governments have provided, and continue to provide, various incentives to encourage the development of the semiconductor industry in China. Such incentives include tax rebates,

reduced tax rates, favorable lending policies, and other measures, some or all of which may be available to our manufacturing partners and to us with respect to the facility we are establishing in China. Any of these incentives could be reduced or eliminated by governmental authorities at any time. Any such reduction or elimination of incentives currently provided to our manufacturing partners could adversely affect our business and operating results.

We may incur additional expenses in connection with the operation of our testing facility in China, which could increase product costs.

We have constructed a new testing facility in China and have begun operations. In addition to the risks discussed elsewhere in this quarterly report, we face the following risks, among others:

- inability to establish appropriate and acceptable manufacturing controls;
- inability to establish sufficient controls and processes for compliance with Section 404 of the Sarbanes-Oxley Act of 2002; and
- higher than anticipated overhead and other costs of operation.

If we are unable to maintain fully operational status with appropriate controls, we may incur higher costs than our current expense levels, which would affect our gross margins. In addition, if capacity restraints result in significant delays in product shipments, our business and results of operations would be adversely affected.

We may be unsuccessful in developing and selling new products or in penetrating new markets required to maintain or expand our business.

Our competitiveness and future success depend on our ability to design, develop, manufacture, assemble, test, market, and support new products and enhancements on a timely and cost-effective basis. A fundamental shift in technologies in any of our product markets could have a material adverse effect on our competitive position within these markets. Our failure to timely develop new technologies or to react quickly to changes in existing technologies could materially delay our development of new products, which could result in product obsolescence, decreased revenue, and/or a loss of market share to competitors.

As we develop new product lines, we must adapt to market conditions that are unfamiliar to us, such as competitors and distribution channels that are different from those we have known in the past. Some of our new product lines require us to re-equip our labs to test parameters we have not tested in the past. If we are unable to adapt rapidly to these new and additional conditions, we may not be able to successfully penetrate new markets.

The success of a new product depends on accurate forecasts of long-term market demand and future technological developments, as well as on a variety of specific implementation factors, including:

- timely and efficient completion of process design and device structure improvements;
- timely and efficient implementation of manufacturing, assembly, and test processes;
- the ability to secure and effectively utilize fabrication capacity in different geometries;
- product performance;

- the quality and reliability of the product; and
- effective marketing, sales and service.

To the extent that we fail to timely introduce new products or to quickly penetrate new markets, our revenue and financial condition could be materially adversely affected.

Because of the lengthy sales cycles for our products and the fixed nature of a significant portion of our expenses, we may incur substantial expenses before we earn associated revenue and may not ultimately achieve our forecasted sales for our products.

The introduction of new products presents significant business challenges because product development plans and expenditures must be made up to two years or more in advance of any sales. It takes us up to 12 months or more to design and manufacture a new product prototype. Only after we have a prototype do we introduce the product to the market and begin selling efforts in an attempt to achieve design wins. This sales process, which averages six to twelve months, requires us to expend significant sales and marketing resources without any assurance of success. Volume production of products that use our ICs, if any, may not be achieved for an additional three to six months after an initial sale. Sales cycles for our products are lengthy for a number of reasons:

- our customers usually complete an in-depth technical evaluation of our products before they place a purchase order;
- the commercial adoption of our products by original equipment manufacturers, or OEMs, and original device manufacturers is typically limited during the initial release of their product to evaluate product performance and consumer demand;
- our products must be designed into a customer s product or system; and
- the development and commercial introduction of our customers products incorporating new technologies frequently are delayed.

As a result of our lengthy sales cycles, we may incur substantial expenses before we earn associated revenue because a significant portion of our operating expenses is relatively fixed and based on expected revenue. The lengthy sales cycles of our products also make forecasting the volume and timing of orders difficult. In addition, the delays inherent in lengthy sales cycles raise additional risks that customers may cancel or change their orders. Our sales are made by purchase orders. Because industry practice allows customers to reschedule or cancel orders on relatively short notice, backlog is not always a good indicator of our future sales. If customer cancellations or product changes occur, we could lose anticipated sales and not have sufficient time to reduce our inventory and operating expenses.

Our products must meet exacting specifications, and undetected defects and failures may occur, which may cause customers to return or stop buying our products and may expose us to product liability risk.

Our customers generally establish demanding specifications for quality, performance, and reliability that our products must meet. Integrated circuits as complex as ours often encounter development delays and may contain undetected defects or failures when first introduced or after commencement of commercial shipments, which might require product replacement or recall. We have from time to time in the past experienced product quality, performance or reliability problems. We have recently extended our standard warranty period from 90 days to one year. As a result, we now have an increased risk of claims for defects and failures. If defects and failures occur in our products, we could experience lost revenue, increased costs, including warranty expense and costs associated with customer support, delays in, cancellations or rescheduling of orders or shipments, and product returns or discounts, any of which would harm our operating results.

In addition, product liability claims may be asserted with respect to our technology or products. Although we currently have insurance, there can be no assurance that we have obtained a sufficient amount of insurance coverage, that asserted claims will be within the scope of coverage of the insurance, or that we will have sufficient resources to satisfy any asserted claims.

We intend to continue to expand our operations, which may strain our resources and increase our operating expenses.

We plan to continue to expand our domestic and foreign operations through internal growth, strategic relationships, or acquisitions. We expect that any such expansion will strain our systems and operational and financial controls, some of which are already in need of improvement as evidenced by the material weaknesses that are described in Item 4 of Part I of this quarterly report on Form 10-Q. In addition, we are likely to incur significantly higher operating costs. To manage our growth effectively, we must continue to improve and expand our systems and controls, as well as hire experienced administrative and financial personnel. If we fail to do so, our growth will be limited. If we fail to effectively manage our planned expansion of operations, our business and operating results may be harmed.

We compete against many companies with substantially greater financing and other resources, and our market share may be reduced if we are unable to respond to our competitors effectively.

The analog and mixed-signal semiconductor industry is highly competitive, and we expect competitive pressures to continue. Our ability to compete effectively and to expand our business will depend on our ability to continue to recruit applications and design talent, our ability to introduce new products, and our ability to maintain the rate at which we introduce these new products. We compete with several domestic and non-domestic semiconductor companies, many of which have substantially greater financial and other resources with which to pursue engineering, manufacturing, marketing, and distribution of their products. We are in direct and active competition, with respect to one or more of our product lines with at least 10 manufacturers of such products, of varying size and financial strength. The number of our competitors has grown due to the expansion of the market segments in which we participate. We consider our competitors to include, but not be limited to: Analog Devices, Fairchild Semiconductor, Intersil Corporation, Linear Technology Corporation, Maxim Integrated Products, Micrel, Microsemi, National Semiconductor Corporation, O2, Semtech Corporation, STMicroelectronic and Texas Instruments. We expect continued competition from existing competitors as well as competition from new entrants in the semiconductor market.

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We cannot assure you that our products will continue to compete favorably or that we will be successful in the face of increasing competition from new products and enhancements introduced by existing competitors or new companies entering this market, which would materially and adversely affect our results of operations and our financial condition.

The future trading price of our common stock could be subject to wide fluctuations in response to a variety of factors.

The future trading price of our common stock is likely to be highly volatile and could be subject to wide fluctuations in price in response to various factors, many of which are beyond our control, including:

- the depth and liquidity of the market for our common stock;
- developments generally affecting the semiconductor industry;
- commencement of or developments relating to our involvement in litigation, including the ongoing O2, Taiwan Sumida Electronics and Linear Technology litigation matters;
- investor perceptions of us and our business;
- changes in securities analysts expectations or our failure to meet those expectations;
- actions by institutional or other large stockholders;
- terrorist acts or acts of war;
- actual or anticipated fluctuations in our results of operations;
- developments with respect to intellectual property rights;
- announcements of technological innovations or significant contracts by us or our competitors;
- introduction of new products by us or our competitors;
- our sale of common stock or other securities in the future;
- conditions and trends in technology industries;

- changes in market valuation or earnings of our competitors;
- changes in the estimation of the future size and growth rate of our markets;
- our results of operations and financial performance; and
- general economic, industry and market conditions.

In addition, the stock market in general often experiences substantial volatility that is seemingly unrelated to the operating performance of particular companies. These broad market fluctuations may adversely affect the trading price of our common stock.

If securities or industry analysts do not continue to publish research or reports about our business, our stock price and trading volume could decline.

The trading market for our common stock will depend on the research and reports that industry or securities analysts publish about us or our business. We do not have any control over these analysts. If one or more of the analysts who cover us downgrade our stock, our stock price would likely decline. If one or more of these analysts cease coverage of the Company or fail to regularly publish reports on us, we could lose visibility in the financial markets, which in turn could cause our stock price or trading volume to decline.

Because of their significant stock ownership, our officers and directors will be able to exert significant influence over our future direction.

Executive officers, directors, and affiliated entities beneficially own in aggregate, approximately 17% of our outstanding common stock. Additionally, Herbert Chang, one of our directors, is associated with InveStar, which owns approximately 14% of our outstanding common stock. These stockholders, if acting together, would be able to significantly influence all matters requiring approval by our stockholders, including the election of directors and the approval of mergers or other business combination transactions.

Major earthquakes or other natural disasters and resulting systems outages may cause us significant losses.

Our corporate headquarters, the production facilities of our third-party wafer supplier, a portion of our assembly and research and development activities, and certain other critical business operations are located in or near seismically active regions and are subject to periodic earthquakes. We do not maintain earthquake insurance and could be materially and adversely affected in the event of a major earthquake. Much of our revenue, as well as our manufacturers and assemblers, are concentrated in

Southeast Asia. Such concentration increases the risk that other natural disasters, labor strikes, terrorism, war, political unrest, epidemics, and/or health advisories could disrupt our operations. In addition, we rely heavily on our internal information and communications systems and on systems or support services from third parties to manage our operations efficiently and effectively. Any of these are subject to failure due to a natural disaster or other disruption. System-wide or local failures that affect our information processing could have material adverse effects on our business, financial condition, operating results, and cash flows.

We may engage in future acquisitions that dilute the ownership interests of our stockholders and cause us to incur debt or to assume contingent liabilities, and we may be unable to successfully integrate these companies into our operations, which would adversely affect our business.

As a part of our business strategy, we may review acquisition prospects that would complement our current product offerings, enhance our design capability or offer other growth opportunities. In the event of future acquisitions, we could use a significant portion of our available cash, issue equity securities which would dilute current stockholders percentage ownership, and/or incur substantial debt or contingent liabilities. Such actions by us could impact our operating results and/or the price of our common stock. In addition, if we are unsuccessful in integrating any acquired company into our operations or if integration is more difficult than anticipated, we may experience disruptions that could harm our business.

ITEM 6. EXHIBITS

10.1 (1)	Settlement Agreement with Micrel, Inc., dated September 21, 2006
10.2(2)#	Letter of agreement between the Company and Victor Lee, dated September 8, 2006
10.3(3)#	2006 Employee Bonus Plan
31.1	Certification of Chief Executive Officer pursuant to Securities Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Chief Financial Officer pursuant to Securities Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1*	Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

1. Filed as Exhibit 10.1 on Form 8-K with the SEC on September 22, 2006
2. Filed as Exhibit 10.1 on Form 8-K with the SEC on September 14, 2006
3. Filed as Exhibit 10.1 on Form 8-K with the SEC on July 28, 2006

\# Denotes management contract or any compensatory plan, contract or arrangement

* This exhibit shall not be deemed filed for purposes of Section 18 of the Securities Exchange Act of 1934 or otherwise subject to the liabilities of that Section, nor shall it be deemed incorporated by reference in any filings under the Securities Act of 1933 or the Securities Exchange Act of 1934, whether made before or after the date hereof and irrespective of any general incorporation language in any filings.

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MONOLITHIC POWER SYSTEMS, INC

SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

MONOLITHIC POWER SYSTEMS, INC.

Dated: November 6, 2006

/s/ C. RICHARD NEELY, JR.
C. Richard Neely, Jr.
Chief Financial Officer
(Principal Financial and Accounting Officer)

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