

DIODES INC /DEL/
Form 10-Q
November 09, 2006

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549**

FORM 10-Q

**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

**o Transition Report Pursuant to Section 13 or 15(d) of
the Securities Exchange Act of 1934
For the transition period from _____ to _____.**

Commission file number: 1-5740

DIODES INCORPORATED

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of
incorporation or organization)

95-2039518

(I.R.S. Employer
Identification Number)

**3050 East Hillcrest Drive
Westlake Village, California**

(Address of principal executive offices)

91362

(Zip code)

(805) 446-4800

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes x No o

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. (Check one)

Large accelerated filer x Accelerated filer o Non-accelerated filer o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o No x

The number of shares of the registrant's Common Stock outstanding as of November 3, 2006 was 25,939,514.

PART I - FINANCIAL INFORMATION**Item 1 - Financial Statements****DIODES INCORPORATED AND SUBSIDIARIES
CONSOLIDATED CONDENSED BALANCE SHEET****ASSETS**

	December 31, 2005	September 30, 2006 (unaudited)
CURRENT ASSETS		
Cash and cash equivalents	\$ 73,288,000	\$ 53,157,000
Short-term investments	40,348,000	56,139,000
Total cash and short-term investments	113,636,000	109,296,000
Accounts receivable		
Customers	48,348,000	70,049,000
Related parties	6,804,000	5,554,000
	55,152,000	75,603,000
Less: Allowance for doubtful receivables	(534,000)	(675,000)
	54,618,000	74,928,000
Inventories	24,611,000	45,767,000
Deferred income taxes, current	2,541,000	2,565,000
Prepaid expenses and other current assets	5,326,000	7,104,000
Total current assets	200,732,000	239,660,000
PROPERTY, PLANT AND EQUIPMENT , at cost, net of accumulated depreciation and amortization	68,930,000	89,168,000
DEFERRED INCOME TAXES , non current	8,466,000	11,043,000
OTHER ASSETS		
Equity investment	5,872,000	-
Goodwill	5,090,000	24,093,000
Other	425,000	2,906,000
TOTAL ASSETS	\$ 289,515,000	\$ 366,870,000

The accompanying notes are an integral part of these financial statements.

**DIODES INCORPORATED AND SUBSIDIARIES
CONSOLIDATED CONDENSED BALANCE SHEET**

LIABILITIES AND STOCKHOLDERS' EQUITY

	December 31, 2005	September 30, 2006 (unaudited)
CURRENT LIABILITIES		
Line of credit	\$ 3,000,000	\$ -
Accounts payable		
Trade	18,619,000	37,250,000
Related parties	7,921,000	13,215,000
Accrued liabilities	19,782,000	27,756,000
Long-term debt, current portion	4,621,000	1,954,000
Capital lease obligations, current portion	138,000	141,000
Total current liabilities	54,081,000	80,316,000
LONG-TERM DEBT , net of current portion	4,865,000	3,709,000
CAPITAL LEASE OBLIGATIONS , net of current portion	1,618,000	1,508,000
MINORITY INTEREST IN JOINT VENTURE	3,477,000	4,321,000
Total liabilities	64,041,000	89,854,000
STOCKHOLDERS' EQUITY		
Preferred stock - par value \$1.00 per share; 1,000,000 shares authorized; no shares issued and outstanding	-	-
Common stock - par value \$0.66 2/3 per share; 70,000,000 shares authorized; 25,258,119 and 25,930,914 shares issued at December 31, 2005 and September 30, 2006, respectively	16,839,000	17,288,000
Additional paid-in capital	94,664,000	111,424,000
Retained earnings	114,659,000	148,126,000
	226,162,000	276,838,000
Less: Accumulated other comprehensive gain (loss)	(688,000)	178,000
Total stockholders' equity	225,474,000	277,016,000
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$ 289,515,000	\$ 366,870,000

The accompanying notes are an integral part of these financial statements.

DIODES INCORPORATED AND SUBSIDIARIES
CONSOLIDATED CONDENSED STATEMENTS OF INCOME
(Unaudited)

	Three Months Ended September		Nine Months Ended September 30,	
	2005	30, 2006	2005	2006
Net sales	\$ 54,200,000	\$ 92,575,000	\$ 153,398,000	\$ 248,876,000
Cost of goods sold	35,323,000	61,879,000	100,428,000	166,532,000
Gross profit	18,877,000	30,696,000	52,970,000	82,344,000
Selling and general administrative expenses	7,581,000	11,825,000	21,469,000	34,883,000
Research and development expenses	938,000	1,941,000	2,688,000	5,985,000
Loss (gain) on disposal of fixed assets	-	32,000	(105,000)	152,000
Total operating expenses	8,519,000	13,798,000	24,052,000	41,020,000
Income from operations	10,358,000	16,898,000	28,918,000	41,324,000
Other income (expense)				
Interest income	23,000	1,069,000	66,000	2,807,000
Interest expense	(188,000)	(89,000)	(465,000)	(363,000)
Other	116,000	(1,563,000)	95,000	(1,699,000)
	(49,000)	(583,000)	(304,000)	745,000
Income before income taxes and minority interest	10,309,000	16,315,000	28,614,000	42,069,000
Income tax provision	(1,621,000)	(3,212,000)	(4,523,000)	(7,778,000)
Income before minority interest	8,688,000	13,103,000	24,091,000	34,291,000
Minority interest in joint venture earnings	(305,000)	(333,000)	(802,000)	(824,000)
Net income	\$ 8,383,000	\$ 12,770,000	\$ 23,289,000	\$ 33,467,000
Earnings per share				
Basic	\$ 0.38	\$ 0.50	\$ 1.08	\$ 1.31
Diluted	\$ 0.34	\$ 0.45	\$ 0.96	\$ 1.19
Number of shares used in computation				
Basic	22,010,235	25,686,913	21,658,863	25,520,156
Diluted	24,731,514	28,152,592	24,344,795	28,055,154

The accompanying notes are an integral part of these financial statements.

DIODES INCORPORATED AND SUBSIDIARIES
CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS
(Unaudited)

	Nine Months Ended September 30,	
	2005	2006
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	\$ 23,289,000	\$ 33,467,000
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	11,887,000	14,053,000
Minority interest earnings	802,000	824,000
Share-based compensation	856,000	5,826,000
Loss (gain) on disposal of property, plant and equipment	(105,000)	221,000
Changes in operating assets:		
Accounts receivable	(5,338,000)	(9,017,000)
Inventories	(4,182,000)	(14,227,000)
Prepaid expenses and others	297,000	(1,493,000)
Deferred income taxes	(1,586,000)	(2,601,000)
Changes in operating liabilities:		
Accounts payable	7,685,000	13,352,000
Accrued liabilities	1,567,000	5,038,000
Income tax payable	2,138,000	1,040,000
Net cash provided by operating activities	37,310,000	46,483,000
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchase of property, plant and equipment	(14,260,000)	(34,768,000)
Proceeds from sale of property, plant and equipment	-	54,000
Purchase of available-for-sale securities	(30,002,000)	(15,791,000)
Acquisitions, net of cash acquired	-	(18,411,000)
Net cash used in investing activities	(44,262,000)	(68,916,000)
CASH FLOWS FROM FINANCING ACTIVITIES		
Repayments of line of credit, net	(3,167,000)	(5,717,000)
Net proceeds from the issuance of common stock	63,565,000	4,111,000
Excess tax benefits	3,116,000	7,274,000
Proceeds from long-term debt	4,509,000	-
Repayments of long-term debt	(4,875,000)	(4,125,000)
Repayments of capital lease obligations	(107,000)	(107,000)
Management incentive reimbursement from LSC	375,000	-
Net cash provided by financing activities	63,416,000	1,436,000
EFFECT OF EXCHANGE RATE CHANGES ON CASH AND CASH EQUIVALENTS		
	(1,221,000)	866,000
INCREASE (DECREASE) IN CASH AND EQUIVALENTS	55,243,000	(20,131,000)

CASH, BEGINNING OF PERIOD	18,970,000	73,288,000
CASH, END OF PERIOD	\$ 74,213,000	\$ 53,157,000

The accompanying notes are an integral part of these financial statements.

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DIODES INCORPORATED AND SUBSIDIARIES
CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS (Continued)
(Unaudited)

SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION	Nine Months Ended September 30,	
	2005	2006
Cash paid during the year for:		
Interest	\$ 456,000	\$ 334,000
Income taxes	\$ 2,049,000	\$ 2,142,000
Non-cash activities:		
Tax benefits related to stock options credited to paid-in capital	\$ 3,116,000	\$ 7,274,000
Property, plant and equipment purchased on accounts payable	\$ 1,990,000	\$ (2,699,000)
The Company purchased 99.81% of capital stock of Anachip Corporation for \$31 million (including \$5.9 million paid in year 2005). In conjunction with the acquisition, liabilities were assumed as follows:		
Fair value of assets acquired		\$ 46,274,000
Cash paid for the capital stock		(28,067,000)
Decrease in payables for business acquisition		(2,445,000)
Liabilities assumed		\$ 15,762,000

The accompanying notes are an integral part of these financial statements.

DIODES INCORPORATED AND SUBSIDIARIES
NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS
(Unaudited)

NOTE A - Basis of Presentation

Unless the context otherwise requires, the words “Diodes,” “we,” “us” and “our” refer to Diodes Incorporated and its subsidiaries. The accompanying unaudited consolidated condensed financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-Q. They do not include all information and footnotes necessary for a fair presentation of financial position, results of operations and cash flows in conformity with accounting principles generally accepted in the United States of America for complete financial statements. These consolidated condensed financial statements should be read in conjunction with the consolidated financial statements and related notes contained in our Annual Report on Form 10-K for the year ended December 31, 2005. In the opinion of management, all adjustments (consisting of normal recurring adjustments and accruals) considered necessary for a fair presentation of the results of operations for the period presented have been included in the interim period. Operating results for the three and nine months ended September 30, 2006 are not necessarily indicative of the results that may be expected for the year ending December 31, 2006. The condensed consolidated financial data at December 31, 2005 is derived from audited financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2005.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from these estimates.

The consolidated financial statements include Diodes-North America and its subsidiaries:

Diodes Taiwan Corporation, Ltd. (“Diodes-Taiwan”) - 100% owned
Diodes Hong Kong Ltd. (“Diodes-Hong Kong”) - 100% owned
Anachip Corporation (Diodes-Anachip) - 99.8% owned
Shanghai KaiHong Electronics Co., Ltd. (“Diodes-China”) - 95% owned
Shanghai KaiHong Technology Co., Ltd. (“Diodes-Shanghai”) - 95% owned
FabTech Incorporated (“FabTech” or “Diodes-FabTech”) - 100% owned

All significant intercompany balances and transactions have been eliminated.

NOTE B - Functional Currencies, Comprehensive Gain/Loss and Foreign Currency Translation

Through our subsidiaries, we maintain operations in Taiwan, Hong Kong and China. We believe the New Taiwan (“NT”) dollar as the functional currency at our Taiwan subsidiaries most appropriately reflects the current economic facts and circumstances of our Taiwan operations. We continue to use the U.S. dollar as the functional currency at our subsidiaries in China and Hong Kong, as substantially all monetary transactions are made in that currency, and other significant economic facts and circumstances currently support that position. As these factors may change in the future, we will periodically assess our position with respect to the functional currency of our foreign subsidiaries.

Accounting principles generally require that recognized revenue, expenses, gains and losses be included in net income. Although certain changes in assets and liabilities are reported as a separate component of the equity section of the balance sheet, such items, along with net income, are components of comprehensive income. The components of other comprehensive income include foreign currency translation adjustments. Accumulated other comprehensive loss was \$688,000 and accumulated other comprehensive gain was \$178,000 at December 31, 2005 and September 30, 2006, respectively. The \$866,000 change was primarily a result of a \$1.1 million one-time adjustment to other

expense for intercompany foreign currency exchange losses that were incorrectly recorded directly to shareholders' equity via other comprehensive loss, rather than by recording to shareholders' equity through the income statement.

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Total comprehensive income for the three and nine months ended September 30, 2005 and 2006 was as follows:

	Three months ended September 30,		Nine months ended September 30,	
	2005	2006	2005	2006
Net income	\$ 8,383,000	\$ 12,770,000	\$ 23,289,000	\$ 33,467,000
Translation adjustment	(1,449,000)	429,000	(1,221,000)	866,000
Comprehensive income	\$ 6,934,000	\$ 13,199,000	\$ 22,068,000	\$ 34,333,000

NOTE C - Inventories

Inventories are stated at the lower of cost or market value. Cost is determined principally by the first-in, first-out method.

	December 31, 2005	September 30, 2006
Finished goods	\$ 14,722,000	\$ 28,310,000
Work-in-progress	3,002,000	8,873,000
Raw materials	9,534,000	13,458,000
	27,258,000	50,641,000
Less: reserves	(2,647,000)	(4,874,000)
	\$ 24,611,000	\$ 45,767,000

NOTE D - Income Tax Provision

We recognized income tax expense of \$3.2 million for the third quarter of 2006, resulting in an effective tax rate of 19.8%, as compared to 15.7% in the same period last year and 19.9% in the second quarter of 2006. Our higher effective tax rate was the result of higher quarterly income in the U.S. at high tax rates, and accrued dividend related taxes in Taiwan. We continue to take advantage of available strategies to optimize our tax rate across the jurisdictions in which we operate. In 2005, we had recorded approximately \$1.1 million in deferred taxes for earnings of our foreign subsidiaries, primarily Diodes-Hong Kong. For the nine months ended September 30, 2006, we have accrued an additional \$1.6 million for taxes on a future dividend from our foreign subsidiaries to the U.S.

Our global presence requires us to pay income taxes in a number of jurisdictions. In general, earnings in the U.S. and Taiwan are currently subject to tax rates of 39.0% and 35.0%, respectively. Earnings of Diodes-Hong Kong are currently subject to a 17.5% tax for local sales or local source sales; all other Hong Kong sales are foreign income tax-free. Earnings at Diodes-Taiwan and Diodes-Hong Kong are also subject to U.S. taxes with respect to those earnings that are derived from product manufactured by our China subsidiaries and sold to customers outside of Taiwan and Hong Kong, respectively. The U.S. tax rate on these earnings is computed as the difference between the foreign effective tax rates and the U.S. tax rate. In accordance with U.S. tax law, we receive credit against our U.S. federal tax liability for income taxes paid by our foreign subsidiaries.

Diodes-China is located in the Songjiang district, where the standard central government tax rate is 24.0%. However, as an incentive for establishing Diodes-China, the earnings of Diodes-China were subject to a 0% tax rate by the central government from 1996 through 2000, and to a 12.0% tax rate from 2001 through 2005. For 2006 and future years, Diodes-China's earnings will continue to be subject to a 12.0% tax rate provided it exports at least 70.0% of its net sales. We currently intend to maintain this volume of exports in the future.

In addition, the earnings of Diodes-China would ordinarily be subject to a standard local government tax rate of 3.0%. However, as an incentive for establishing Diodes-China, the local government waived this tax from 1996 through the third quarter of 2006. Management expects this tax to be waived for at least the remainder of 2006; however, the local government can re-impose this tax at any time in its discretion.

In 2004, we established Diodes-Shanghai located in the Songjiang Export Zone of Shanghai, China. In the Songjiang Export Zone, the central government's standard tax rate is 15.0%. There is no local government tax in this zone.

As an incentive for establishing Diodes-Shanghai, for 2005 and 2006, the earnings of Diodes-Shanghai are exempted from central government income tax, and for the years 2007 through 2009 its earnings will be subject to a 7.5% tax rate. From 2010 onward, provided that Diodes-Shanghai exports over 70.0% of its net sales, the earnings will be subject to a 10.0% tax rate. We currently intend to maintain this volume of exports in the future.

As an incentive for the formation of Anachip, earnings of Anachip are subject to a five-year tax holiday (subject to certain qualifications of Taiwanese tax law). In the third quarter of 2006, we elected to begin this five-year tax holiday as of January 1, 2006.

NOTE E - Share-based Compensation

We maintain share-based compensation plans for our Board of Directors ("Directors"), officers, and key employees, which provide for stock options and stock awards. The plans are described more fully in Note 9 of our audited financial statements included in the Annual Report on Form 10-K for the year ended December 31, 2005.

Stock Options. Through March 31, 2006, substantially all stock options granted vest in equal annual installments over a three-year period and expire ten years after the grant date. Beginning April 1, 2006, substantially all stock options granted vest in equal annual installments over a four-year period and expire ten years after the grant date.

Beginning in fiscal year 2006, we adopted Statement of Financial Accounting Standards (SFAS) No. 123R, "Share-Based Payments" (SFAS 123R), on a modified prospective transition method to account for our employee stock options. Under the modified prospective transition method, fair value of new and previously granted but unvested stock options are recognized as compensation expense in the income statement, and prior period results are not restated, and thus do not include the additional compensation expense. In the three and nine months ended September 30, 2006, operating income decreased by \$1.6 million and \$5.0 million, respectively, net income decreased by \$1.4 million and \$4.3 million, respectively, and diluted earnings per share were reduced by \$0.04 and \$0.13, respectively. For the three and nine months ended September 30, 2006, stock-based compensation expense associated with the Company's stock options recognized in the income statement is as follows:

	September 30, 2006	
	Three Months Ended	Nine Months Ended
Selling and administrative expense	\$ 1,355,000	\$ 4,112,000
Research and development expense	\$ 146,000	\$ 438,000
Cost of sales	\$ 133,000	\$ 398,000

Total share-based compensation expense	\$	1,634,000	\$	4,948,000
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Share-based compensation expense for the three and nine months ended September 30, 2006 for stock options granted during the quarter was calculated on the date of grant using the Black-Scholes option pricing model with the following weighted-average assumptions:

	September 30, 2006	
	Three Months Ended	Nine Months Ended
Expected volatility	56.03%	53.85%
Expected term (in years)	6.57	5.86
Risk-free interest rate	5.07%	4.70%
Expected forfeitures	2.56%	2.56%

Expected volatility. The Company estimates expected volatility using historical volatility. Public trading volume on options in the Company's stock is not material. As a result, the Company determined that utilizing an implied volatility factor would not be appropriate. The Company calculates historical volatility for the period that is commensurate with the option's expected term assumption.

Expected term. The Company has evaluated expected term based on history and exercise patterns across its demographic population. The Company believes that this historical data is the best estimate of the expected term of a new option. The expected term for officers and Directors is 6.57 years, while the expected term for all other employees is 5.88 years.

Risk free interest rate. The Company estimated the risk-free interest rate based on zero-coupon U.S. Treasury securities for a period that is commensurate with the expected term assumption.

Forfeiture rate. The amount of stock-based compensation recognized during a period is based on the value of the portion of the awards that are ultimately expected to vest as SFAS 123R requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. The term "forfeitures" is distinguished from "cancellations" or "expirations" and represents only the unvested portion of the surrendered option. The Company has applied an annual forfeiture rate of 2.56% to all unvested options as of September 30, 2006. This analysis will be re-evaluated at least annually, and the forfeiture rate will be adjusted as necessary.

Dividend yield. The Company historically has not paid a cash dividend; therefore this input is not applicable.

For the three and nine months ended September 30, 2006, the Company granted stock options to purchase 10,000 and 265,780 shares of the Company's Common Stock, respectively, which vest in equal annual installments over a three or four-year period and expire ten years from the date of grant. Options granted in the three and nine months ended September 30, 2006 had a weighted-average grant date fair value of \$25.12 and \$18.95, respectively.

The total intrinsic value (actual gain) of options exercised during the nine months ended September 30, 2006 was approximately \$21.7 million.

At September 30, 2006, un-amortized compensation expense related to unvested options, net of forfeitures, was approximately \$11.0 million. The weighted average period over which share-based compensation expense related to these options will be recognized is 2.2 years.

A summary of the stock option plans as of September 30, 2006 follows:

Stock options	Shares (000)	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (yrs)	Aggregate Intrinsic Value (\$000)
Outstanding at December 31, 2005	4,095	\$ 10.45		
Granted	266	34.33		
Exercised	(673)	6.11		
Forfeited or expired	(54)	24.05		
Outstanding at September 30, 2006	3,634	\$ 12.51	6.5	\$ 110,453
Exercisable at September 30, 2006	2,646	\$ 8.88	5.8	\$ 90,712

Prior to our adoption of SFAS 123R, Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" (SFAS 123) provided an alternative to APB Opinion No. 25, "Accounting for Stock Issued to Employees" (APB 25), in accounting for stock-based compensation issued to employees. SFAS 123 provided for a fair value based method of accounting for employee stock options and similar equity instruments. However, companies that continued to account for stock-based compensation arrangements under APB 25 were required by SFAS 123 to disclose, in the notes to financial statements, the pro forma effects on net income and net income per share as if the fair value based method prescribed by SFAS 123 had been applied. Prior to our adoption of SFAS 123R, we accounted for stock-based compensation using the provisions of APB 25 and presented the pro forma information required by SFAS 123 as amended by Statement of Financial Accounting Standards No. 148, "Accounting for Stock-Based Compensation-Transition and Disclosure" (SFAS 148).

Had the Company accounted for stock-based compensation plans using the fair value based accounting method described by SFAS 123R for the periods prior to fiscal year 2006, the Company's earnings per common share, basic and diluted, for the three and nine months ended September 30, 2005, would have approximated the following:

	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2005
Net income, as reported	\$ 8,383,000	\$ 23,289,000
Deduct: Total stock-based compensation expense determined under fair value based method for all awards, net of tax benefits	(824,000)	(1,907,000)
Pro forma net income	\$ 7,559,000	\$ 21,382,000
Earnings per share:		
Basic		
- as reported	\$ 0.38	\$ 1.08
- pro forma	\$ 0.35	\$ 0.99
Diluted		
- as reported	\$ 0.34	\$ 0.96
- pro forma	\$ 0.29	\$ 0.88

Share Grants. Restricted stock awards and restricted stock units generally vest in equal annual installments over a four-year period.

A summary of the status of the Company's non-vested share grants as of September 30, 2005 and September 30, 2006 are presented below:

Nonvested Shares	Shares (000)	Weighted-Average Grant-Date Fair Value
Nonvested at January 1, 2005	—	—
Granted	330	\$ 17.30
Vested	—	—
Forfeited	—	—
Nonvested at September 30, 2005	330	\$ 17.30

Nonvested Shares	Shares (000)	Weighted-Average Grant-Date Fair Value
Nonvested at January 1, 2006	330	\$ 17.30
Granted	204	33.96
Vested	—	—
Forfeited	—	—
Nonvested at September 30, 2006	534	\$ 23.66

During the nine months ended September 30, 2006 and September 30, 2005, there were \$878,000 and \$856,000 of total recognized share-based compensation expense related to non-vested stock award arrangements granted under the plans, respectively.

The total of unrecognized share-based compensation expense as of September 30, 2006 and September 30, 2005 was \$9.8 million and \$4.9 million, respectively.

NOTE F -Segment Information

An operating segment is defined as a component of an enterprise about which separate financial information is available that is evaluated regularly by the chief decision maker, or decision making group, in deciding how to allocate resources and in assessing performance. Our chief decision-making group consists of the President and Chief Executive Officer, Chief Financial Officer, Senior Vice President of Finance, Senior Vice President of Sales and Marketing, and Senior Vice President of Operations. We operate in a single segment, semiconductor devices, through our various manufacturing and distribution facilities.

Our operations include the domestic operations (Diodes-North America and Diodes-FabTech) located in the United States, and the Far East operations (Diodes-Taiwan located in Taipei, Taiwan; Anachip Corporation located in HsinChu, Taiwan; Diodes-China and Diodes-Shanghai, both located in Shanghai, China; and Diodes-Hong Kong located in Hong Kong, China). For reporting purposes, European operations, which accounted for approximately 3.2% and 3.5% of total sales for the three and nine months ended September 30, 2006, respectively (2.7% for the third quarter of 2005, and 2.6% for the nine months ended September 30, 2005), are consolidated into the domestic (North America) operations.

The accounting policies of the operations are the same as those described in the summary of significant accounting policies. Revenues are attributed to geographic areas based on the location of the market producing the revenues.

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Three Months Ended September 30, 2005	Far East	North America	Consolidated Segments
Total sales	\$ 62,622,000	\$ 23,229,000	\$ 85,851,000
Inter-company sales	(26,460,000)	(5,191,000)	(31,651,000)
Net sales	\$ 36,162,000	\$ 18,038,000	\$ 54,200,000
Property, plant and equipment	\$ 53,601,000	\$ 11,279,000	\$ 64,880,000
Assets	\$ 155,330,000	\$ 109,237,000	\$ 264,567,000

Three Months Ended September 30, 2006	Far East	North America	Consolidated Segments
Total sales	\$ 113,717,000	\$ 30,636,000	\$ 144,353,000
Inter-company sales	(46,559,000)	(5,219,000)	(51,778,000)
Net sales	\$ 67,158,000	\$ 25,417,000	\$ 92,575,000
Property, plant and equipment	\$ 76,161,000	\$ 13,007,000	\$ 89,168,000
Assets	\$ 227,454,000	\$ 139,416,000	\$ 366,870,000

Nine Months Ended September 30, 2005	Far East	North America	Consolidated Segments
Total sales	\$ 171,425,000	\$ 66,153,000	\$ 237,578,000
Inter-company sales	(71,108,000)	(13,072,000)	(84,180,000)
Net sales	\$ 100,317,000	\$ 53,081,000	\$ 153,398,000
Property, plant and equipment	\$ 53,601,000	\$ 11,279,000	\$ 64,880,000
Assets	\$ 155,330,000	\$ 109,237,000	\$ 264,567,000

Nine Months Ended September 30, 2006	Far East	North America	Consolidated Segments
Total sales	\$ 287,102,000	\$ 89,248,000	\$ 376,350,000
Inter-company sales	(110,825,000)	(16,649,000)	(127,474,000)
Net sales	\$ 176,277,000	\$ 72,599,000	\$ 248,876,000
Property, plant and equipment	\$ 76,161,000	\$ 13,007,000	\$ 89,168,000
Assets	\$ 227,454,000	\$ 139,416,000	\$ 366,870,000

Geographic Information

Revenues were derived from (invoiced to) customers located in the following countries. “All Others” represents countries with less than 20% of total revenues each.

	Net Sales for the three months ended September 30, 2005		Percentage of net sales	
	2005	2006	2005	2006
	(Dollars in thousands)			
Taiwan	\$ 16,383	\$ 35,014	30.2%	37.8%
China	17,318	24,840	32.0%	26.8%
United States	13,377	20,038	24.7%	21.6%
All Others	7,122	12,683	13.1%	13.8%
Total	\$ 54,200	\$ 92,575	100.0%	100.0%

	Net Sales for the nine months ended September 30, 2005		Percentage of net sales	
	2005	2006	2005	2006
	(Dollars in thousands)			
China	\$ 42,854	\$ 78,209	27.9%	31.4%
Taiwan	49,989	73,993	32.6%	29.7%
United States	38,534	57,600	25.1%	23.1%
All Others	22,021	39,074	14.4%	15.8%
Total	\$ 153,398	\$ 248,876	100.0%	100.0%

NOTE G - Business Acquisition

On December 20, 2005, the Company entered into a definitive stock purchase agreement to acquire Anachip Corporation, a Taiwanese fabless analog IC company.

Headquartered in the Hsinchu Science Park in Taiwan, Anachip’s main product focus is Power Management ICs. Anachip's products are widely used in LCD monitor/TV's, wireless 802.11 LAN access points, brushless DC motor fans, portable DVD players, datacom devices, ADSL modems, TV/satellite set-top boxes, and power supplies.

The selling shareholders of Anachip stock included Lite-On Semiconductor Corporation (“LSC”) (which owned approximately 60% of Anachip’s outstanding capital stock), and two Taiwanese venture capital firms (together owning approximately 20% of Anachip’s stock), as well as current and former Anachip employees.

At December 31, 2005, the Company had purchased an aggregate of 9,433,613 shares (or approximately 18.9%) of the 50,000,000 outstanding shares of the capital stock of Anachip. On January 10, 2006, (the closing date of the acquisition) the Company purchased an additional 40,470,212 shares and therefore, the Company holds approximately 99.81% of the Anachip capital stock. At December 31, 2005, the investment in Anachip is recorded under the equity method; however, the Company did not record income from the investment on the consolidated financial statements for the ten days ending December 31, 2005, as the amount was not material. As a result of the additional Anachip interest acquired during 2006, Anachip was consolidated beginning the first fiscal quarter of 2006.

The purchase price of the acquisition was NT\$20 per share (approximately US\$31 million). The following table summarizes management's preliminary estimates of the fair values of the assets acquired and liabilities assumed at the date of acquisition. The allocation of the purchase price is subject to refinement for final determination of fair value.

	Original Amount Disclosed in 2005 Form 10-K (unaudited)	Purchase Adjustments	Total Allocation
Current assets	\$ 23,752,000	\$ (1,121,000)	\$ 22,631,000
Fixed assets/non-current	2,045,000	(46,000)	1,999,000
Intangible assets			0
Patents and trademarks	2,269,000	125,000	2,394,000
Computer cost	246,000	0	246,000
Goodwill	19,541,000	(537,000)	19,004,000
Total assets acquired	47,853,000	(1,579,000)	46,274,000
Current liabilities	(16,829,000)	1,369,000	(15,460,000)
Non-current liabilities	(655,000)	353,000	(302,000)
Total liabilities assumed	(17,484,000)	1,722,000	(15,762,000)
Total purchase price	\$ 30,369,000	\$ 143,000	\$ 30,512,000

Purchase adjustments primarily relate to acquisition costs and refinement to estimated fair values of assets acquired and liabilities assumed.

The acquired intangible assets include patents and trademarks of \$2.4 million with an approximately 10-year weighted-average useful life, and computer costs of \$246,000 with a weighted-average useful life of approximately 3-7 years. The recorded goodwill was assigned primarily to the analog IC segment.

The following unaudited table summarizes the supplemental pro forma information for the three months and nine months ended September 30, 2005 as though the acquisition had been completed as of the beginning of that reporting period. The pro forma information is presented for illustrative purposes and is not indicative of future performance.

	Three months ended September 30, 2005	
	As reported	Pro forma
Revenue	\$ 54,200,000	\$ 67,737,000
Net income	8,383,000	9,575,000
Earnings per share		
Basic	\$ 0.38	\$ 0.44
Diluted	\$ 0.34	\$ 0.39
	Nine months ended September 30, 2005	
	As reported	Pro forma
Revenue	\$ 153,398,000	\$ 188,844,000

Net income	23,289,000	24,943,000
Earnings per share		
Basic	\$ 1.08	\$ 1.15
Diluted	\$ 0.96	\$ 1.02

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NOTE H - Commitments

In April 2006, the Company signed an agreement to purchase a new building with a contract price of approximately \$6.0 million. This facility is used to consolidate and expand our sales, administrative, and warehousing offices in Taipei, Taiwan. As of September 30, 2006, the Company had temporarily used all cash to purchase the building, but subsequently converted it to approximately 80% bank financing in October 2006.

NOTE I - Adjustments to Share-Based and Other Expense

Management believes two errors existed in our accounting treatment for certain transactions related to prior reporting periods. In consideration of Staff Accounting Bulletin No. 108, management assessed the impact of the following errors and determined the errors were immaterial, and did not, individually and in the aggregate, materially impact the consolidated financial position, net income or earnings per share for any of the affected annual and quarterly results: (i) an overstatement of operating expense for the year ended December 31, 2005 in the amount of \$0.8 million relating to the expensing of restricted share grants resulted when we incorrectly marked-to-market the quarterly share grant expense rather than fixing the expense based on the market price of our common stock on the date the award was granted, and (ii) an understatement of other expense in the amounts of \$0.1 million, \$0.1 million, \$0.2 million, and \$0.7 million for the years ended December 31, 2002, 2003, 2004, and 2005, respectively, which arose when we incorrectly assessed the long-term nature of our intercompany accounts, and eliminated intercompany foreign currency exchange losses by recording the losses directly to shareholders' equity via other comprehensive loss, rather than recording to shareholders' equity through the income statement. In the quarter ended September 30, 2006, we made a one-time adjustment to the relevant accounts, and the tax adjusted net result was a decrease to net income of approximately \$0.6 million.

NOTE J - Subsequent Events

In October 2006, the Company issued \$230 million in aggregate principal convertible senior notes due on October 1, 2026. The notes will pay interest semiannually at a rate of 2.25% per annum, with a 39.68% conversion premium, and with any conversion premium redeemable into cash and/or shares of common stock at the Company's option. The pre-tax net investment interest income to the Company, at current market rates, is projected to be approximately \$5.0 to \$5.5 million per year.

On October 24, 2006, the Company signed an agreement to purchase the net assets of APD Semiconductor, a privately held U.S.-based fabless discrete semiconductor company. The asset acquisition included a \$7.0 million payment for patents, technology, and trademarks, and approximately \$1.0 million for net working capital, which is in addition to a potential earnout provision. The acquisition was completed on November 3, 2006. The Company is in the process of obtaining third-party valuations of certain intangible assets to define the allocation of aggregate purchase cost.

NOTE K - Reclassifications

In the first quarter of 2006, we adopted Statement of Financial Accounting Standards (SFAS) No. 123R, "Share-Based Payments," using the modified prospective method. SFAS 123R requires that the excess tax benefit associated with an individual share-based payment award be included in the statement of cash flows as a cash inflow from financing activities and a cash outflow from operating activities. The 2005 amounts presented in the accompanying financial statements have been reclassified to conform to 2006 financial statement presentation. These reclassifications had no impact on previously reported net income or stockholders' equity.

NOTE L - Recently Issued Accounting Pronouncements

In September 2006, Financial Accounting Standards Board (“FASB”) issued FAS 158, *Employers’ Accounting for Defined Benefit Pension and Other Postretirement Plans - an Amendment of FASB Statements No. 87, 88, 106 and 132(R)* (“FAS 158”). FAS 158 requires an employer that is a business entity and sponsors one or more single employer benefit plans to (1) recognize the funded status of the benefit in its statement of financial position, (2) recognize as a component of other comprehensive income, net of tax, the gains or losses and prior service costs or credits that arise during the period, but are not recognized as components of net periodic benefit cost, (3) measure defined benefit plan assets and obligations as of the date of the employer's fiscal year end statement of financial position and (4) disclose in the notes to financial statements additional information about certain effects on net periodic benefit cost for the next fiscal year that arise from delayed recognition of the gains or losses, prior service costs on credits, and transition asset or obligations. We do not expect FAS 158 to have a material impact on our consolidated financial statements.

In September 2006, the FASB issued FAS 157, *Fair Value Measurements* (“FAS 157”). FAS 157 clarifies the principle that fair value should be based on the assumptions market participants would use when pricing an asset or liability and establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. Under the standard, fair value measurements would be separately disclosed by level within the fair value hierarchy. FAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years, with early adoption permitted. The Company has not yet determined the effect, if any, that the implementation of FAS 157 will have on our consolidated results of operations or financial condition.

In September 2006, the Securities and Exchange Commission (“SEC”) issued Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* (“SAB 108”). SAB 108 provides interpretive guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatement. The SEC staff believes that registrants should quantify errors using both a balance sheet and an income statement approach and evaluate whether either approach results in quantifying a misstatement that, when all relevant quantitative and qualitative factors are considered, is material. SAB 108 is effective for the Company’s fiscal year ending December 31, 2006. We do not expect SAB 108 to have a material impact on our consolidated financial statements.

In July 2006, the FASB issued FASB interpretation (FIN) No. 48, "Accounting for Uncertainty in Income Taxes" which clarifies the accounting for uncertainty in income taxes recognized in an enterprise’s financial statements in accordance with FASB Statement No. 109, "Accounting for Income Taxes". This Interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This Interpretation also provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company is currently evaluating the potential impact of this standard on its consolidated financial position and results of operations. It is not expected to have a significant impact on the Company’s consolidated financial statements upon adoption.

In May 2005, the Financial Accounting Standards Board (FASB) issued FAS 154, “Accounting Changes and Error Corrections, A Replacement of APB Opinion No. 20 and FASB Statement No. 3.” FAS 154 requires retrospective application to prior periods’ financial statements for changes in accounting principles, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. FAS 154 also requires that retrospective application of a change in accounting principle be limited to the direct effects of the change. Indirect effects of a change in accounting principle, such as a change in non-discretionary profit-sharing payments resulting from an accounting change, should be recognized in the period of the accounting change. FAS 154 also requires that a change in depreciation, amortization, or depletion method for long-lived, non-financial assets be accounted for as a change in accounting estimate affected by a change in accounting principle. FAS 154 is effective for accounting

changes and corrections of errors made in fiscal years beginning after December 15, 2005. Early adoption is permitted for accounting changes and corrections of errors made in fiscal years beginning after the date this Statement is issued. The Company does not anticipate a material impact on the consolidated financial statements from the adoption of this consensus.

Item 2 - Management's Discussion and Analysis of Financial Condition and Results of Operations

Except for the historical information contained herein, the matters addressed in this Item 2 constitute "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Such forward-looking statements are subject to a variety of risks and uncertainties, including those discussed below under the heading "Risk Factors" and elsewhere in this Quarterly Report on Form 10-Q, that could cause actual results to differ materially from those anticipated by the Company's management. The Private Securities Litigation Reform Act of 1995 (the "Act") provides certain "safe harbor" provisions for forward-looking statements. All forward-looking statements made on this Quarterly Report on Form 10-Q are made pursuant to the Act. The Company undertakes no obligation to publicly release the results of any revisions to their forward-looking statements that may be made to reflect events or circumstances after the date hereof or to reflect the occurrence of unexpected events. Unless the context otherwise requires, the words "Diodes," "we," "us" and "our" refer to Diodes Incorporated and its subsidiaries.

This management's discussion should be read in conjunction with the management's discussion included in the Company's Annual Report on Form 10-K for the fiscal year-ended December 31, 2005 previously filed with Securities and Exchange Commission.

Overview

We are a global supplier of discrete and analog semiconductor products. We design, manufacture and market these semiconductors focusing on diverse end-use applications in the consumer electronics, computing, industrial, communications and automotive sectors. Our semiconductors, which provide electronic signal amplification and switching functions, are basic building-block electronic components that are incorporated into almost every electronic device. We believe that our product focus provides us with a meaningful competitive advantage relative to broadline semiconductor companies that provide a wider range of semiconductor products.

We are headquartered in Westlake Village, California, near Los Angeles. Our two manufacturing facilities are located in Shanghai, China; our wafer fabrication facility is near Kansas City, Missouri; our sales and marketing and logistical centers are located in Taipei, Taiwan, and Shanghai and Shenzhen, China, and Hong Kong; and our newly acquired fabless IC design company, Anachip, is located in Hsinchu, Taiwan. We also have regional sales offices or representatives in: Derbyshire, England; Toulouse, France; Frankfurt, Germany; and in various cities in the United States.

In 1998, we began to transform our business from the distribution of discrete semiconductors manufactured by others to the design, manufacture and marketing of discrete semiconductor products using our internal manufacturing capabilities. The key elements of our strategy of transforming our business from a distribution-based model to one primarily based on the design and manufacture of proprietary products are:

- expanding our manufacturing capacity, including establishing integrated state-of-the-art packaging and testing facilities in Asia in 1998 and 2004, and acquiring a wafer foundry in the United States in 2000;
- expanding our sales and marketing organization in Asia in order to address the shift of manufacturing of electronics products from the United States to Asia;
 - establishing our sales and marketing organization in Europe commencing in 2002; and
- expanding the number of our field application engineers to design our products into specific end-user applications.

In implementing this strategy, the following factors have affected, and, we believe, will continue to affect, our results of operations:

- Since 1998, we have experienced increases in the demand for our products, and substantial pressure from our customers and competitors to reduce the selling price of our products. We expect future increases in net income to result primarily from increases in sales volume and improvements in product mix in order to offset reduced average selling prices of our products.
- As part of our growth strategy, in January 2006 we acquired Anachip Corporation, a fabless Taiwanese semiconductor company focused on the standard analog markets. The acquisition, which closed on January 10, 2006, fits in the center of our long-term strategy. Anachip's main product focus is Power Management ICs. The analog devices they produce are used in LCD monitor/TV's, wireless LAN 802.11 access points, brushless DC motor fans, portable DVD players, datacom devices, ADSL modems, TV/satellite set-top boxes, and power supplies. Anachip brings a design team with strong capabilities in a range of targeted analog and power management technologies. We paid approximately \$31 million to acquire Anachip, which had power management IC revenues of approximately \$35 million in 2005. The acquisition was accretive to our first nine months of 2006 earnings, and is expected to be accretive to our full-year 2006 earnings.
- In 2005 and the nine months ended September 30, 2006, 15.3% and 26.2%, respectively, of our net sales were derived from products introduced within the last three years, which we term "new products," compared to 14.3% in 2004. The significant increase in new products primarily resulted from the Anachip acquisition. New products generally have gross profit margins that are higher than the margins of our standard products. We expect net sales derived from new products to increase in absolute terms, although our net sales of new products as a percentage of our net sales will depend on the demand for our standard products, as well as our product mix.
- Our gross profit margin was 33.2% in the third quarter of 2006, compared to 34.8% in the same period of 2005. As expected, our gross margin percentage was lower as we are in the early stages of our manufacturing integration of the analog product line. With the addition of Anachip, we can now pursue adjacent product categories that significantly expand our growth opportunities as well as gross margin potential.
 - As of September 30, 2006, we had invested approximately \$117.3 million in our Asian manufacturing facilities. For the three and nine months ended September 30, 2006, we invested approximately \$4.9 million and \$32.4 million, respectively, in capital expenditures, primarily in our Asian manufacturing facilities. Excluding our non-production related \$6.0 million Taiwan building purchase, year-to-date capital expenditures were at approximately 10.6% of revenue. Our full-year capital expenditure estimate is at 10-12% of our total revenue. Our capital expenditure objective is to meet increased demand by investing in equipment to increase our manufacturing efficiencies, and to integrate the analog business.
- During the third quarter of 2006, the percentage of our net sales derived from our Asian subsidiaries was 72.5%, compared to 70.1% in the second quarter of 2006, 65.4% in 2005 and 59.1% in 2004. We expect our net sales to the Asian market to continue to increase as a percentage of our total net sales as a result of our customers' continuing to shift their manufacturing of electronic products from the U.S. to Asia.
- We have increased our investment in research and development from \$938,000, or 1.7% of net sales in the third quarter of 2005 to \$1.9 million, or 2.1% of net sales, in the third quarter of 2006, as we completed the Anachip acquisition, continued investing in enhancing current product features, and developed new products. We continue to seek to hire qualified engineers who fit our focus on proprietary discrete and analog processes and packaging technologies. Our goal is to expand research and development expenses to between 2.5% and 3.0% of net sales as we bring additional proprietary devices to the market.

- During 2005, we sold 3.2 million (split adjusted) shares of our Common Stock in a follow-on public offering, raising approximately \$72.0 million (net of commissions and expenses). We used approximately \$31 million of the net proceeds to acquire Anachip and will use the remaining net proceeds from this offering for working capital and other general corporate purposes, including additional acquisitions.

- On November 3, 2006, we completed the agreement to purchase the assets of APD Semiconductor, a privately held U.S.-based fabless discrete semiconductor company. Headquartered in Redwood City, California, APD's main product focus is its patented and trademarked Super Barrier Rectifier™ technology. The asset acquisition included a \$7 million payment for patents, technology, and trademarks, and approximately \$1 million for net working capital, which is in addition to a potential earnout provision. APD revenue is forecasted to be approximately \$2.0 million for 2006. For 2007, we project the revenue generated from the APD product line to exceed the purchase price, and that the acquisition will be accretive to our bottom-line. The APD acquisition is aligned with our strategy of strengthening our technology leadership in the discrete semiconductor market and expanding our product capabilities across important segments of our end-markets.
- On October 5, 2006, we issued \$230 million in aggregate principal convertible senior notes due on October 1, 2026. The notes pay interest semiannually at a rate of 2.25% per annum. The notes will be convertible, in certain circumstances, into cash up to the principal amount, and any conversion value above the principal amount will be redeemable, at our option, into cash or shares of Common Stock, at an initial conversion rate of 17.0946 shares per \$1,000 principal amount of notes (which represents an initial conversion price of \$58.50 per share). The initial conversion price represents a 39.68% conversion premium, based on the last reported sale price of \$41.88 of Company's Common Stock on October 5, 2006. The Company expects this transaction to be accretive to earnings per share given the current short-term interest environment and intends to use the net proceeds from this offering for working capital and other general corporate purposes, including acquisitions.

Related Parties

We conduct business with two related party companies, Lite-On Semiconductor Corporation ("LSC") (and its subsidiaries and affiliates) and Keylink International (formerly Xing International) (and its subsidiaries). LSC is our largest stockholder and owned 22.3% of our outstanding Common Stock as of September 30, 2006. Keylink International is our 5% joint venture partner in Diodes-China and Diodes-Shanghai. C.H. Chen, our previous President and Chief Executive Officer, and Vice Chairman of our Board of Directors, is also Vice Chairman of LSC. M.K. Lu, a member of our Board of Directors, is President of LSC, while Raymond Soong, the Chairman of our Board of Directors, is the Chairman of Lite-On Technology Corporation, a significant shareholder of LSC, as well as Chairman of LSC.

The Audit Committee of our Board of Directors reviews all related party transactions for potential conflict of interest situations, and approves all such transactions, in accordance with such procedures as it may adopt from time to time. We believe that all related party transactions are on terms no less favorable to us than would be obtained from unaffiliated third parties.

During the three and nine months ended September 30, 2006, we sold silicon wafers to LSC totaling 6.2% and 6.4%, (9.6% in 2005 and 11.1% in 2004) of our net sales, respectively, making LSC our largest customer. Also for the three and nine months ended September 30, 2006, 13.1% and 13.4% (14.7% in 2005 and 17.2% in 2004) of our net sales were from discrete semiconductor products purchased from LSC for subsequent sale by us, making LSC our largest outside supplier. In addition, companies affiliated with LSC, which we refer to collectively as The Lite-On Group, accounted for 3.3%, 4.2% and 2.6% of our net sales, respectively, in 2004, 2005 and the third quarter of 2006. We also rent warehouse space in Hong Kong from a member of The Lite-On Group, which also provides us with warehousing services at that location. For 2004, 2005 and the nine months ended September 30, 2006, we reimbursed this entity in aggregate amounts of \$190,000, \$288,000 and \$313,000, respectively, for these items. We believe such transactions are on terms no less favorable to us than could be obtained from unaffiliated third parties. The Audit Committee of our Board of Directors has approved the contracts associated with these related party transactions.

In December 2000, we acquired a wafer foundry, FabTech, Inc., from LSC for approximately \$6.0 million cash plus \$19.0 million in assumed debt (the debt was due primarily to LSC). In connection with the acquisition, LSC entered into a volume purchase agreement to purchase wafers from FabTech. In addition, in accordance with the terms of the acquisition, we also entered into several management incentive agreements with members of FabTech's management. The agreements provided members of FabTech's management with guaranteed annual payments as well as contingent bonuses based on the annual profitability of FabTech, subject to a maximum annual amount. Any portion of the guaranteed and contingent liability paid by FabTech was reimbursed by LSC. The final year of the management incentive agreements was 2004, with final payment made on March 31, 2005. LSC reimbursed us \$375,000 in 2003, 2004, and 2005 for each of 2002, 2003 and 2004, for amounts paid by us under these management incentive agreements.

During the three and nine months ended September 30, 2006, we sold silicon wafers to companies owned by Keylink International totaling 0.6% and 0.4%, respectively, (0.6% in 2005 and 0.9% in 2004) of our net sales. Also for the three and nine months ended September 30, 2006, 2.2% and 2.5% (3.0% in 2005 and 3.5% in 2004) of our net sales were from discrete semiconductor products purchased from companies owned by Keylink International, respectively. In addition, Diodes-China and Diodes-Shanghai lease their manufacturing facilities from, and subcontract a portion of their manufacturing process (metal plating and environmental services) to, Keylink International. We also pay a consulting fee to Keylink International. In 2005, and the three and nine months ended September 30, 2006, we paid Keylink International an aggregate of \$6.6 million, \$2.2 million and \$6.2 million, respectively, with respect to these items, respectively. We believe such transactions are on terms no less favorable to us than could be obtained from unaffiliated third parties. The Audit Committee of our Board of Directors has approved the contracts associated with these related party transactions.

On December 20, 2005, we entered into a definitive stock purchase agreement to acquire Anachip Corporation, a Taiwanese fabless analog IC company, and headquartered in the Hsinchu Science Park in Taiwan. The selling shareholders included LSC (which owned approximately 60% of Anachip's outstanding capital stock), and two Taiwanese venture capital firms (together owning approximately 20% of Anachip's stock), as well as current and former Anachip employees. At December 31, 2005, we had purchased an aggregate of 9,433,613 shares (or approximately 18.9%) of the 50,000,000 outstanding shares of the capital stock of Anachip. On January 10, 2006 (the closing date of the acquisition), we purchased an additional 40,470,212 shares and therefore, we now hold approximately 99.81% of the Anachip capital stock.

Concurrent with the acquisition, Anachip entered into a wafer purchase agreement with LSC, pursuant to which LSC will sell to Anachip, according to Anachip's requirements, during the two year period ending on December 31, 2007, wafers of the same or similar type, and meeting the same specifications, as those wafers purchased from LSC by Anachip at the time of the acquisition. Anachip will purchase such wafers on terms (including purchase price, delivery schedule, and payment terms) no less favorable to Anachip than those terms on which Anachip purchased such wafers from LSC at the time of the acquisition provided, however, that the purchase price will be the lower of the current price or the most favorable customer pricing. If the price of raw wafers increases by more than 20% within any six-month period, Anachip and LSC will renegotiate in good faith the price of wafers to reflect the cost increase.

Available Information

Our Internet address is <http://www.diodes.com>. We make available, free of charge through our Internet website, our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, proxy statements, and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act as soon as reasonably practicable after such material is electronically filed with or furnished to the Securities and Exchange Commission (the "SEC"). To support our global customer-base, particularly in Asia and Europe, our website is language-selectable into English, Chinese, and Korean, giving us an effective marketing tool for worldwide markets. With its extensive online Product (Parametric) Catalog with advanced search capabilities, our website facilitates quick and easy product selection. Our website provides easy access to worldwide sales contacts and customer support, and incorporates a distributor-inventory check to provide component inventory availability and a small order desk for overnight sample fulfillment. Our website also provides access to investor financial information, including SEC filings and press releases, as well as stock quotes and information on corporate governance compliance.

Cautionary Statement for Purposes of the “Safe Harbor” Provision of the Private Securities Litigation Reform Act of 1995

Except for the historical information contained herein, the matters addressed in this Quarterly Report on Form 10-Q constitute “forward-looking statements” within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. We generally identify forward-looking statements by the use of terminology such as “may,” “will,” “could,” “should,” “potential,” “continue,” “expect,” “intend,” “estimate,” “anticipate,” “believe,” or similar phrases or the negatives of such terms. Such forward-looking statements are subject to a variety of risks and uncertainties, including those discussed under “Risks Related To Our Business” and elsewhere in this Quarterly Report on Form 10-Q that could cause actual results to differ materially from those anticipated by our management. The Private Securities Litigation Reform Act of 1995 (the “Act”) provides certain “safe harbor” provisions for forward-looking statements. All forward-looking statements made on this Quarterly Report on Form 10-Q are made pursuant to the Act.

All forward-looking statements contained in this Quarterly Report on Form 10-Q are subject to, in addition to the other matters described in this Quarterly Report on Form 10-Q, a variety of significant risks and uncertainties. The following discussion highlights some of these risks and uncertainties. Further, from time to time, information provided by us or statements made by our employees may contain forward-looking information. There can be no assurance that actual results or business conditions will not differ materially from those set forth or suggested in such forward-looking statements as a result of various factors, including those discussed below.

For more detailed discussion of these factors, see the “Risk Factors” discussion in Item 1A of the Company’s most recent Annual Report on Form 10-K. The forward-looking statements included in this Quarterly Report on Form 10-Q are made only as of the date of this report, and the Company undertakes no obligation to update the forward-looking statements to reflect subsequent events or circumstances.

Risks Related To Our Business

- *Downturns in the highly cyclical semiconductor industry or changes in end-market demand could affect our operating results and financial condition.*
- *The semiconductor business is highly competitive, and increased competition may harm our business and our operating results.*
- *We receive a significant portion of our net sales from a single customer. In addition, this customer is also our largest external supplier and is a related party. The loss of this customer or supplier could harm our business and results of operations.*
- *Delays in initiation of production at new facilities, implementing new production techniques or resolving problems associated with technical equipment malfunctions could adversely affect our manufacturing efficiencies.*
- *We are and will continue to be under continuous pressure from our customers and competitors to reduce the price of our products, which could adversely affect our growth and profit margins.*
- *Our customer orders are subject to cancellation or modification usually with no penalty. High volumes of order cancellation or reductions in quantities ordered could adversely affect our results of operations and financial condition.*
- *New technologies could result in the development of new products by our competitors and a decrease in demand for our products, and we may not be able to develop new products to satisfy changes in demand, which could result in a*

decrease in net sales and loss of market share.

- We may be subject to claims of infringement of third-party intellectual property rights or demands that we license third-party technology, which could result in significant expense and reduction in our intellectual property rights.*

- *We depend on third-party suppliers for timely deliveries of raw materials, parts and equipment, as well as finished products from other manufacturers, and our results of operations could be adversely affected if we are unable to obtain adequate supplies in a timely manner.*
- *If we do not succeed in continuing to vertically integrate our business, we will not realize the cost and other efficiencies we anticipate and our ability to compete, profit margins and results of operations may suffer.*
- *Part of our growth strategy involves identifying and acquiring companies with complementary product lines or customers. We may be unable to identify suitable acquisition candidates or consummate desired acquisitions and, if we do make any acquisitions, we may be unable to successfully integrate any acquired companies with our operations.*
- *We are subject to many environmental laws and regulations that could affect our operations or result in significant expenses.*
- *Our products may be found to be defective and, as a result, product liability claims may be asserted against us, which may harm our business and our reputation with our customers.*
- *We may fail to attract or retain the qualified technical, sales, marketing and management personnel required to operate our business successfully.*
- *We may not be able to maintain our growth or achieve future growth and such growth may place a strain on our management and on our systems and resources.*
- *Our business may be adversely affected by obsolete inventories as a result of changes in demand for our products and change in life cycles of our products.*
- *If OEMs do not design our products into their applications, a portion of our net sales may be adversely affected.*
- *We rely heavily on our internal electronic information and communications systems, and any system outage could adversely affect our business and results of operations.*
- *We are subject to interest rate risk that could have an adverse effect on our cost of working capital and interest expenses.*
- *If we fail to maintain an effective system of internal controls or discover material weaknesses in our internal controls over financial reporting, we may not be able to report our financial results accurately or detect fraud, which could harm our business and the trading price of our Common Stock.*
- *Terrorist attacks, or threats or occurrences of other terrorist activities whether in the United States or internationally may affect the markets in which our Common Stock trades, the markets in which we operate and our profitability.*
- *We currently have a significant amount of debt following our convertible senior notes offering. Our substantial indebtedness could adversely affect our business, financial condition and results of operations and our ability to meet our payment obligations under the notes and our other debt.*

Risks Related To Our International Operations

- *Our international operations subject us to risks that could adversely affect our operations.*
- *We have significant operations and assets in China, Taiwan and Hong Kong and, as a result, will be subject to risks inherent in doing business in those jurisdictions, which may adversely affect our financial performance.*
 - *We are subject to foreign currency risk as a result of our international operations.*
- *We may not continue to receive preferential tax treatment in China, thereby increasing our income tax expense and reducing our net income.*
- *The distribution of any earnings of our foreign subsidiaries to the United States may be subject to U.S. income taxes, thus reducing our net income.*

Risks Related To Our Common Stock

- *Variations in our quarterly operating results may cause our stock price to be volatile.*
- *We may enter into future acquisitions and take certain actions in connection with such acquisitions that could affect the price of our Common Stock.*
- *Our directors, executive officers and significant stockholders hold a substantial portion of our Common Stock, which may lead to conflicts with other stockholders over corporate transactions and other corporate matters.*
- *Our early corporate records are incomplete. As a result, we may have difficulty in assessing and defending against claims relating to rights to our Common Stock purporting to arise during periods for which our records are incomplete.*
- *Conversion of our convertible senior notes will dilute the ownership interest of existing shareholders, including holders who had previously converted their notes.*

Financial Operations Overview

Net Sales

We generate a substantial portion of our net sales through the sale of discrete and analog semiconductor products designed and manufactured by third parties or us. We also generate a portion of our net sales from outsourcing manufacturing capacity to third parties and from the sale of silicon wafers to manufacturers of discrete semiconductor components. We serve customers across diversified industries, including the consumer electronics, computing, industrial, communications and automotive markets.

We recognize revenue from product sales when title to and risk of loss of the product have passed to the customer, there is persuasive evidence of an arrangement, the sale price is fixed or determinable and collection of the related receivable is reasonably assured. These criteria are generally met upon shipment to our customers. Net sales is stated net of reserves for pricing adjustments, discounts, rebates and returns.

The principal factors that have affected or could affect our net sales from period to period are:

- the condition of the economy in general and of the semiconductor industry in particular;
 - our customers' adjustments in their order levels;
- changes in our pricing policies or the pricing policies of our competitors or suppliers;
 - the termination of key supplier relationships;

- the rate of introduction of new products to, and acceptance by, our customers;
- our ability to compete effectively with our current and future competitors;
- our ability to enter into and renew key corporate and strategic relationships with our customers, vendors and strategic alliances;
- changes in foreign currency exchange rates;
- a major disruption of our information technology infrastructure; and
- unforeseen catastrophic events, such as armed conflict, terrorism, fires, typhoons and earthquakes.

Cost of Goods Sold

Cost of goods sold includes manufacturing costs for our semiconductor products and our wafers. These costs include raw materials used in our manufacturing processes as well as the labor costs and overhead expenses. Cost of goods sold is also impacted by yield improvements, capacity utilization and manufacturing efficiencies. In addition, cost of goods sold includes the cost of products that we purchase from other manufacturers and sell to our customers. Cost of goods sold is also affected by inventory obsolescence if our inventory management is not efficient.

Selling, General and Administrative Expenses

Selling, general and administrative expenses relate primarily to compensation and associated expenses for personnel in general management, sales and marketing, information technology, engineering, human resources, procurement, planning and finance, and sales commissions, as well as outside legal, accounting and consulting expenses, share-based compensation expenses, and other operating expenses. We expect our selling, general and administrative expenses to increase in absolute dollars as we hire additional personnel and expand our sales, marketing and engineering efforts and information technology infrastructure.

Research and Development Expenses

Research and development expenses consist of compensation and associated costs of employees engaged in research and development projects, as well as materials and equipment used for these projects. Research and development expenses are primarily associated with our wafer facility near Kansas City, Missouri, our analog IC facilities in Taipei, Taiwan, and our manufacturing facilities in China, as well as our engineers at our U.S. headquarters. All research and development expenses are expensed as incurred, and we expect our research and development expenses to increase in absolute dollars as we invest in new technologies and product lines.

Interest Income / Expense

Interest income consists of interest earned on our cash and investment balances. Interest expense consists of interest payable on our outstanding credit facilities.

Income Tax Provision

We recognized income tax expense of \$3.2 million for the third quarter of 2006, resulting in an effective tax rate of 19.7%, as compared to 15.7% in the same period last year. Our higher effective tax rate was primarily the result of higher quarterly income in the U.S. at high tax rates. Going forward, we anticipate our tax rate to be comparable to that of the third quarter. We continue to take advantage of available strategies to optimize our tax rate across the

jurisdictions in which we operate.

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Critical Accounting Policies and Estimates

The preparation of financial statements in accordance with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. On an on-going basis, we evaluate our estimates, including those related to revenue recognition, allowance for doubtful accounts, inventory reserves and income taxes, among others. Our estimates are based upon historical experiences, market trends and financial forecasts and projections, and upon various other assumptions that management believes to be reasonable under the circumstances and at that certain point in time. Actual results may differ, significantly at times, from these estimates under different assumptions or conditions.

We believe the following critical accounting policies and estimates affect the significant estimates and judgments we use in the preparation of our consolidated financial statements, and may involve a higher degree of judgment and complexity than others.

Revenue Recognition

We recognize revenue when there is persuasive evidence that an arrangement exists, when delivery has occurred, when our price to the buyer is fixed or determinable and when collectability of the receivable is reasonably assured. These elements are met when title to the products is passed to the buyers, which is generally when our product is shipped.

We reduce revenue in the period of sale for estimates of product returns, distributor price adjustments and other allowances, the majority of which are related to our North American operations. Our reserve estimates are based upon historical data as well as projections of revenues, distributor inventories, price adjustments, average selling prices and market conditions. Actual returns and adjustments could be significantly different from our estimates and provisions, resulting in an adjustment to revenues.

Inventory Reserves

Inventories are stated at the lower of cost or market value. Cost is determined principally by the first-in, first-out method. On an on-going basis, we evaluate our inventory, both finished goods and raw material, for obsolescence and slow-moving items. This evaluation includes analysis of sales levels, sales projections, and purchases by item, as well as raw material usage related to our manufacturing facilities. Based upon this analysis, as well as an inventory aging analysis, we accrue a reserve for obsolete and slow-moving inventory. If future demand or market conditions are different than our current estimates, an inventory adjustment may be required, and would be reflected in cost of goods sold in the period the revision is made.

Accounting for Income Taxes

As part of the process of preparing our consolidated financial statements, we are required to estimate our income taxes in each of the tax jurisdictions in which we operate. This process involves using an asset and liability approach whereby deferred tax assets and liabilities are recorded for differences in the financial reporting bases and tax bases of our assets and liabilities. Significant management judgment is required in determining our provision for income taxes, deferred tax assets and liabilities. Management continually evaluates its deferred tax asset as to whether it is likely that the deferred tax assets will be realized. If management ever determined that our deferred tax asset was not likely to be realized, a write-down of the asset would be required and would be reflected as an expense in the accompanying period.

Allowance for Doubtful Accounts

Management evaluates the collectability of our accounts receivable based upon a combination of factors, including the current business environment and historical experience. If we are aware of a customer's inability to meet its financial obligations to us, we record an allowance to reduce the receivable to the amount we reasonably believe we will be able to collect from the customer. For all other customers, we record an allowance based upon the amount of time the receivables are past due. If actual accounts receivable collections differ from these estimates, an adjustment to the allowance may be necessary with a resulting effect on operating expense.

Impairment of Long-Lived Assets

As of September 30, 2006, goodwill was \$24.1 million (\$19.0 million related to the Anachip acquisition, \$4.2 million related to the FabTech acquisition, and \$881,000 related to Diodes-China). We account for goodwill in accordance with SFAS No. 142, "*Goodwill and Other Intangible Assets*," for which goodwill is tested for impairment at least annually. We performed the required impairment tests of goodwill and have determined that the goodwill is fully recoverable.

We assess the impairment of long-lived assets, including goodwill, on an on-going basis and whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Our impairment review process is based upon (i) an income approach from a discounted cash flow analysis, which uses our estimates of revenues, costs and expenses, as well as market growth rates, and (ii) a market multiples approach which measures the value of an asset through an analysis of recent sales or offerings or comparable public entities. If ever the carrying value of the goodwill is determined to be less than the fair value of the underlying asset, a write-down of the asset will be required, with the resulting expense charged in the period that the impairment was determined.

Share-Based Compensation

Effective in January 1, 2006, we adopted SFAS No. 123R, "Share-Based Payments," using the modified prospective method. Under SFAS 123R, we are required to select a valuation technique or option-pricing model that meets the criteria as stated in the standard, which includes a binomial model and the Black-Scholes model. At the present time, the Company is continuing to use the Black-Scholes model, consistent with prior period valuations under SFAS 123. No modifications were made to any outstanding share-options prior to the adoption of SFAS 123R.

The adoption of SFAS 123R, applying the "modified prospective method," as elected by the Company, requires the Company to value stock options prior to its adoption of SFAS 123 under the fair value method and expense these amounts over the stock options' remaining vesting period. This resulted in the Company expensing \$1.6 million and \$5.0 million in the third quarter and nine months ended September 30, 2006, respectively, which was recorded within the cost of goods sold expense, general and administrative expense and research and development expense on the Company's condensed consolidated income statement. In addition, SFAS 123R requires the Company to reflect any tax savings resulting from tax deductions in excess of expense reflected in its financial statements as a financing cash inflow in its statement of cash flows rather than as an operating cash flow as in prior periods (See "Note E - Share-based Compensation" for details). The Company has changed its primary award type to employees from stock options to stock awards as an improved method of employee reward and retention. In general, the Company extended the vesting period from three years to four years, and reduced the number of shares subject to the award by a factor of three.

The Company has 533,600 restricted stock grants outstanding as of September 30, 2006. The restricted stock grants will be recorded each quarter as a non-cash operating expense item. As of September 30, 2006, there was \$9.8 million of total unrecognized compensation cost related to non-vested share-based compensation. This cost is expected to be recognized over a weighted-average period of 3.1 years. In the third quarter of 2006, an expense of \$107,000 was

recorded. In addition to the expense, the effect of the restricted stock grants are included in the diluted shares outstanding calculation.

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Adjustments to Share-Based and Other Expense

Management believes two errors existed in our accounting treatment for certain transactions related to prior reporting periods. In consideration of Staff Accounting Bulletin No. 108, management assessed the impact of the following errors and determined the errors were immaterial, and did not, individually and in the aggregate, materially impact the financial position, net income or earnings per share for any of the affected annual and quarterly results: (i) an overstatement of operating expense for the year ended December 31, 2005 in the amount of \$0.8 million relating to the expensing of restricted share grants resulted when we incorrectly marked-to-market the quarterly share grant expense rather than fixing the expense based on the market price of our common stock on the date the award was granted, and (ii) an understatement of other expense in the amounts of \$0.1 million, \$0.1 million, \$0.2 million, and \$0.7 million for the years ended December 31, 2002, 2003, 2004, and 2005, respectively, which arose when we incorrectly assessed the long-term nature of our intercompany accounts, and eliminated intercompany foreign currency exchange losses by recording the losses directly to shareholders' equity via other comprehensive loss, rather than recording to shareholders' equity through the income statement. In the quarter ended September 30, 2006, we made a one-time adjustment to the relevant accounts, and the tax adjusted net result was a decrease to net income of approximately \$0.6 million.

Results of Operations for the Three Months Ended September 30, 2005 and 2006

The following table sets forth, for the periods indicated, the percentage that certain items in the statement of income bear to net sales and the percentage dollar increase (decrease) of such items from period to period.

	Percent of Net Sales		Percentage Dollar Increase (Decrease) '05 to '06
	2005	2006	
Net sales	100.0%	100.0%	70.8%
Cost of goods sold	(65.2)	(66.8)	75.2
Gross profit	34.8	33.2	62.6
Operating expenses	(15.7)	(14.9)	62.0
Operating income	19.1	18.3	63.1
Interest expense, net	(0.3)	1.1	(693.9)
Other income	0.2	(1.7)	(1,447.4)
Income before taxes and minority interest	19.0	17.7	58.3
Income tax provision	(3.0)	(3.5)	98.1
Income before minority interest	16.0	14.3	50.8
Minority interest	(0.6)	(0.4)	9.2
Net income	15.4	13.8	52.3

The following discussion explains in greater detail our consolidated operating results and financial condition for the three months ended September 30, 2006 compared to the three months ended September 30, 2005. This discussion should be read in conjunction with the consolidated financial statements and notes thereto appearing elsewhere in this quarterly report.

	2005	2006
<u>Net sales</u>	\$ 54,200,000	\$ 92,575,000

Net sales increased approximately \$38.4 million for the three months ended September 30, 2006, compared to the same period last year, due primarily to sales of analog products related to the acquisition of Anachip. The 70.8% increase in net sales represents an approximately 46.1% increase in units sold. Our average selling prices (“ASP”) for discrete devices decreased approximately 1.7% from the third quarter of 2005, and decreased 0.5% from the first quarter of 2006, due primarily to demand induced product mix changes in the quarter. ASPs for wafer products however, increased approximately 12.4% from the same period last year, and improved 0.7% sequentially, due primarily to market price changes. ASPs for analog IC products declined approximately 3.7% from the previous quarter due primarily to product mix changes.

	2005	2006
<u>Cost of goods sold</u>	\$ 35,323,000	\$ 61,879,000
<u>Gross profit</u>	\$ 18,877,000	\$ 30,696,000
<u>Gross profit margin percentage</u>	34.8%	33.2%

Cost of goods sold increased approximately \$26.6 million, or 75.2%, for the three months ended September 30, 2006 compared to the same period in 2005, primarily due to sales of analog products related to the integration of Anachip at lower margins. As a percent of sales, cost of goods sold increased from 65.2% for the three months ended September 30, 2005 to 66.8% for the three months ended September 30, 2006. Our average unit cost (“AUP”) for discrete devices decreased approximately 2.3% from the third quarter of 2005, but increased 3.4% from the second quarter of 2006. AUPs for wafer products increased approximately 15.1% in the third quarter of 2006 from the same period last year, but decreased 4.2% from the second quarter of 2006. AUPs for analog IC products decreased approximately 3.4% from the previous quarter. The sequential decreases in AUPs for discrete products were due primarily to improved manufacturing efficiencies and utilization. As per SFAS 123R, included in cost of goods sold was \$133,000 of non-cash, stock option compensation expense related to our manufacturing facilities.

Gross profit increased in the third quarter of 2006 by approximately \$11.8 million, or 62.6%, compared to the three months ended September 30, 2005. Gross margin, as a percentage of net sales, decreased to 33.2% for the three months ended September 30, 2006, compared to 34.8% for the same period of 2005, due to sales of analog product.

	2005	2006
<u>SG&A</u>	\$ 7,581,000	\$ 11,825,000

SG&A for the three months ended September 30, 2006 increased approximately \$4.2 million, or 56.0%, compared to the same period last year, due primarily to (i) an approximately \$1.4 million increase in non-cash, stock option compensation expense due to our adoption of SFAS 123R, (ii) higher sales commissions, wages and marketing expenses associated with the acquisition of Anachip and increased sales, and (iii) audit, legal and consulting expenses associated with Sarbanes-Oxley Act compliance, as well as our IT infrastructure. SG&A, as a percentage of sales, was 12.8% in the current quarter, down from 14.0% in the prior-year quarter, due primarily to the adjustment for the overstatement of restricted share grant expense recorded in 2005. For comparable purposes, excluding the share-based compensation, SG&A for the third quarter of 2006 would have been 11.3% of sales.

	2005	2006
<u>R&D</u>	\$ 938,000	\$ 1,941,000

Investment in R&D in the current quarter was \$1.9 million, an increase of approximately \$1.0 million from that in the same period last year. Of the \$1.0 million increase, \$586,000 reflected the impact of the acquisition of Anachip and Diodes' investment in developing new products in discrete, analog and mixed signal segments, while \$146,000 was associated with stock option compensation expense due to our adoption of SFAS 123R. R&D, as a percentage of sales, was 2.1% of third quarter 2006 sales compared to 1.7% in the same period 2005.

	2005	2006
<u>Interest income (expense), net</u>	\$ (165,000)	\$ 980,000

Net interest income for the three months ended September 30, 2006 was \$980,000, compared to the net interest expense of \$165,000 in the same period 2005, due primarily to interest income earned on proceeds from our public offering of equity securities in 2005.

	2005	2006
<u>Other income (expense)</u>	\$ 116,000	\$ (1,563,000)

Other expense for the three months ended September 30, 2006 was \$1,563,000, compared to other income of \$116,000 in the third quarter of 2005. Included in other expense for the third quarter of 2006 was an approximate \$1.1 million one-time adjustment due to the understatement of intercompany currency exchange losses at our Taiwan subsidiary for the years ended December 2002 through 2005.

	2005	2006
<u>Income tax provision</u>	\$ 1,621,000	\$ 3,212,000

We recognized income tax expense of \$3.2 million for the third quarter of 2006, resulting in an effective tax rate of 19.7%, as compared to 15.7% in the same period last year. Our higher effective tax rate is primarily the result of higher quarterly income in the U.S. at higher tax rates, and accrued dividend related taxes in Taiwan.

	2005	2006
<u>Minority interest in joint venture earnings</u>	\$ 305,000	\$ 333,000

Minority interest in joint venture earnings represented the minority investor's share of the earnings of Diodes-China, Diodes-Shanghai and Anachip's for the period. The joint venture investments were eliminated in the consolidations of our financial statements, and the activities of Diodes-China, Diodes-Shanghai and Anachip were included therein. As of September 30, 2006, we had 95% controlling interests in Diodes-China and Diodes-Shanghai, and a 99.8% controlling interest in Anachip.

Results of Operations for the Nine Months Ended September 30, 2005 and 2006

The following table sets forth, for the periods indicated, the percentage that certain items in the statement of income bear to net sales and the percentage dollar increase (decrease) of such items from period to period.

	Percent of Net Sales		Percentage
	Nine months ended September 30,		Dollar
	2005	2006	Increase
			(Decrease)
			'05 to '06
Net sales	100.0%	100.0%	62.2%
Cost of goods sold	(65.5)	(66.9)	65.8
Gross profit	34.5	33.1	55.5
Operating expenses	(15.7)	(16.5)	70.5
Operating income	18.8	16.6	42.9
Interest expense, net	(0.3)	1.0	(712.5)
Other income	0.1	(0.7)	(1,888.4)
Income before taxes and minority interest	18.6	17.0	47.0
Income tax provision	(2.9)	(3.1)	72.0
Income before minority interest	15.7	13.8	42.3
Minority interest	(0.5)	(0.3)	2.7
Net income	15.2	13.5	43.7

The following discussion explains in greater detail our consolidated operating results and financial condition for the nine months ended September 30, 2006 compared to the nine months ended September 30, 2005. This discussion should be read in conjunction with the consolidated financial statements and notes thereto appearing elsewhere in this quarterly report.

	2005	2006
Net sales	\$ 153,398,000	\$ 248,876,000

Net sales increased approximately \$95.5 million for the nine months ended September 30, 2006, compared to the same period last year, due primarily to sales of analog products related to the acquisition of Anachip. The 62.2% increase in net sales represents an approximately 44.0% increase in units sold. Our ASPs for discrete devices decreased approximately 4.8% from the same nine-month period last year due primarily to demand induced product mix changes. ASPs for wafer products increased approximately 4.7% from the same period last year, due primarily to more favorable market pricing.

	2005	2006
Cost of goods sold	\$ 100,428,000	\$ 166,532,000
Gross profit	\$ 52,970,000	\$ 82,344,000
Gross profit margin percentage	34.5%	33.1%

Cost of goods sold increased approximately \$66.1 million, or 65.8%, for the nine months ended September 30, 2006 compared to the same period in 2005, primarily due to sales of analog products related to the integration of Anachip at lower margins. As a percent of sales, cost of goods sold increased from 65.5% for the nine months ended September 30, 2005 to 66.9% for the nine months ended September 30, 2006. Our AUPs for discrete devices decreased approximately 5.3% from the same nine-month period of 2005, while increasing 6.3% for wafer products from the same period last year. The decreases in AUPs for discrete products were due primarily to improved manufacturing efficiencies and utilization. As per SFAS 123R, included in cost of goods sold was \$398,000 of non-cash, share-based compensation expense related to our manufacturing facilities.

Gross profit for the nine months ended September 30, 2006 increased approximately \$29.4 million, or 55.5%, compared to the nine months ended September 30, 2005. Gross margin as a percentage of net sales was at 33.1% for the nine months ended September 30, 2006, down from 34.5% for the same period of 2005.

	2005	2006
SG&A	\$ 21,469,000	\$ 34,883,000

SG&A for the nine months ended September 30, 2006 increased approximately \$13.4 million, or 62.5%, compared to the same period last year, due primarily to (i) an approximately \$4.1 million increase associated with non-cash, share-based compensation expense due to our adoption of SFAS 123R, (ii) higher sales commissions, wages and marketing expenses associated with the acquisition of Anachip and increased sales, and (iii) audit and legal expenses associated with Sarbanes-Oxley Act compliance. SG&A for the current nine-month period was 14.0% of sales, compared to 14.0% in the same nine-month period last year. Included in SG&A for the nine months ended September 30, 2006 was an approximate \$620,000 adjustment due to an overstatement of restricted share grant expense recorded in 2005. For comparable purposes, excluding the share-based compensation, SG&A for the nine months ended September 30, 2006 would have been 12.3% of sales.

	2005	2006
R&D	\$ 2,688,000	\$ 5,985,000

Investment in R&D during the first nine months of 2006 was \$6.0 million, an increase of approximately \$3.3 million from the same period last year. Of the \$3.3 million increase, \$2.0 million reflected the impact of the acquisition of Anachip and Diodes' investment in developing new products in discrete, analog and mixed signal segments, while \$438,000 was associated with share-based compensation expense due to our adoption of SFAS 123R. R&D, as a percentage of sales, was 2.4% for the current nine-month period compared to 1.8% in the same period 2005.

	2005	2006
Interest income (expense), net	\$ (399,000)	\$ 2,444,000

Net interest income for the nine months ended September 30, 2006 was \$2,444,000, compared to the net interest expense of \$399,000 in the same period 2005, due primarily to interest income earned on proceeds from our public offering of equity securities in 2005.

	2005	2006
<u>Other income (loss)</u>	\$ 95,000	\$ (1,699,000)

Other loss for the nine months ended September 30, 2006 was \$1.7 million, compared to \$95,000 for the same period of 2005. Included in other expense for the nine months ended September 30, 2006, was an approximate \$1.1 million one-time adjustment due to the understatement of intercompany currency exchange losses at our Taiwan subsidiary for the years ended December 2002 through 2005.

	2005	2006
<u>Income tax provision</u>	\$ 4,523,000	\$ 7,778,000

We recognized income tax expense of \$7.8 million for the first nine months ended September 30, 2006, resulting in an effective tax rate of 18.5%, as compared to 15.8% in the same period last year. Our higher effective tax rate was the result of higher quarterly income in the U.S. at higher tax rates, and accrued dividend related taxes in Taiwan.

	2005	2006
<u>Minority interest in joint venture earnings</u>	\$ 802,000	\$ 824,000

Minority interest in joint venture earnings represented the minority investor's share of the earnings of Diodes-China, Diodes-Shanghai and Anachip's for the period. The joint venture investments were eliminated in the consolidations of our financial statements, and the activities of Diodes-China, Diodes-Shanghai and Anachip were included therein. As of September 30, 2006, we had 95% controlling interests in Diodes-China and Diodes-Shanghai, and a 99.8% controlling interest in Anachip.

Financial Condition

Liquidity and Capital Resources

Our primary sources of liquidity are cash, funds from operations and borrowings under our credit facilities. Our primary liquidity requirements have been to meet our inventory and capital expenditure needs. At December 31, 2005 and September 30, 2006, our working capital was \$146.7 million and \$159.3 million, respectively. We anticipate our working capital position will be sufficient for at least the next 12 months.

During 2005, we sold 3.2 million (stock split adjusted) shares of our Common Stock in a follow-on public offering, raising approximately \$72 million (net of commissions and expenses). We used approximately \$31 million of the net proceeds in connection with the Anachip acquisition, and we intend to use the remaining net proceeds from this offering for working capital and other general corporate purposes, including additional acquisitions.

Capital expenditures for the current quarter were \$4.9 million and \$32.4 million year-to-date (including a \$6 million office building purchase in Diodes-Taiwan during the second quarter). Our capital expenditures for these periods were primarily related to manufacturing expansion in our facilities in China and, to a lesser extent, our wafer fabrication facility in the U.S. Excluding this non-production related \$6 million building purchase, year-to-date capital expenditures were at approximately 10.6% of revenue as of September 30, 2006, which is in the range of our 10-12% full-year estimate.

In addition, we paid \$18.9 million in conjunction with the closing of the Anachip acquisition in January 2006.

Discussion of Cash Flow

Cash and short-term investments have decreased from \$113.6 million at December 31, 2005, to \$109.3 million at September 30, 2006. The decrease from 2005 to 2006 was primarily due to capital expenditures as well as the Anachip acquisition.

Operating Activities

Net cash provided by operating activities during the first nine months of 2006 was \$46.5 million, resulting primarily from \$33.5 million of net income in this period, as well as a \$14.1 million in depreciation and amortization. Net cash provided by operating activities was \$37.3 million for the same period in 2005. Net cash provided by operations increased by \$9.2 million for the first nine months from 2005 to 2006. This increase resulted primarily from an approximately \$10.2 million increase in our net income (from \$23.3 million in 2005 to \$33.5 million in 2006), \$5.0 million increase in non-cash, share-based compensation expense, and \$2.2 million increase in depreciation and amortization expense, offset by increases in inventory, prepaid expenses and accounts receivables. We continue to closely monitor our credit terms with our customers, while at times providing extended terms, primarily required by our customers in Asia and Europe.

Investing Activities

Net cash used by investing activities was \$68.9 million for the first nine months of 2006 compared to \$44.3 million for the same period of 2005. The increase in investing activities primary relates to increases in capital expenditures of \$20.6 million, including the \$6 million office building purchase in Taiwan, and the final acquisition payment for Anachip of \$18.4 million (net of cash acquired).

Financing Activities

Net cash provided by financing activities totaled \$2.0 million in the first nine months of 2006 compared to \$63.4 million provided in the same period of 2005. This decrease is primarily the result of the proceeds received from the secondary offering during the third quarter of 2005.

Debt Instruments

On August 29, 2005, we amended our U.S. credit arrangements with Union Bank of California, N.A. (Union Bank). Under the second amendment to our amended and restated credit agreement, we now have available a revolving credit commitment of up to \$20.0 million, including a \$5.0 million letter of credit sub-facility. In addition, and in connection with this amendment, one of our subsidiaries, Diodes-FabTech, also amended and restated a term note and related agreement with respect to an existing term loan arrangement, which we refer to as the FabTech term loan. After giving effect to this amendment, the principal amount under the FabTech term loan was increased to \$5.0 million.

The revolving credit commitment expires on August 29, 2008. The FabTech term loan, which amortizes monthly, matures on August 29, 2010. As of September 30, 2006, we had no amounts outstanding under our revolving credit facility, and there was \$3.9 million outstanding under the FabTech term loan. Loans to Diodes Incorporated under our credit facility are guaranteed by FabTech, and in turn, the FabTech term loan is guaranteed by Diodes Incorporated. The purpose of the revolving credit facility is to provide cash for domestic working capital purposes, and to fund permitted acquisitions.

Any amounts borrowed under the credit facility and the FabTech term loan are collateralized by all of Diodes Incorporated's and FabTech's accounts, instruments, chattel paper, documents, general intangibles, inventory, equipment, furniture and fixtures, pursuant to security agreements entered into by Diodes Incorporated and FabTech in connection with these credit arrangements.

Both amounts borrowed under the revolving credit facility and the FabTech term loan bear interest at LIBOR plus 1.15%. At September 30, 2006, the effective rate under both the credit agreement and the FabTech term loan was 6.51%.

The credit agreement contains covenants that require us to maintain a leverage ratio not greater than 2.25 to 1.0, an interest expense coverage ratio of not less than 2.0 to 1 and a current ratio of not less than 1.0 to 1. It also requires us to achieve a net profit before taxes, as of the last day of each fiscal quarter, for the two consecutive fiscal quarters ending on that date of not less than \$1. The credit agreement permits us to pay dividends to our stockholders to the extent that any such dividends declared or paid in any fiscal year do not exceed an amount equal to 50% of our net profit after taxes for such fiscal year. However, it limits our ability to dispose of assets, incur additional indebtedness, engage in liquidation or merger, acquisition, partnership or other combination (except permitted acquisitions). The credit agreement also contains customary representations, warranties, affirmative and negative covenants and events of default. As of September 30, 2006, we were in compliance with the bank covenants.

The agreements governing the FabTech term loan do not contain any financial or negative covenants. However, they provide that a default under our credit agreement will cause a cross-default under the FabTech term loan.

As of September 30, 2006, our Asia subsidiaries have available lines of credit of up to an aggregate of \$42.2 million, with a number of Chinese and Taiwanese financial institutions. These lines of credit, except for one Taiwanese credit facility, are collateralized by its premises, are unsecured, uncommitted and, in some instances, may be repayable on demand. Loans under these lines of credit bear interest at LIBOR or similar indices plus a specified

margin.

As of September 30, 2006, Diodes-China owed \$1.7 million under a note to one of our customers, which debt was incurred in connection with our investing in manufacturing equipment. We repay this unsecured and interest-free note in quarterly price concession installments, with any remaining balance due in July 2008.

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In October 2006, the Company issued \$230 million in aggregate principal amount of convertible senior notes due on October 1, 2026. The notes will pay interest semiannually at a rate of 2.25% per annum, with a 39.68% conversion premium, and with any conversion premium redeemable into cash and/or shares of common stock at the Company's option. The pre-tax net investment interest income to the Company, at current market rates, is projected to be approximately \$5.0 to \$5.5 million per year.

Off-Balance Sheet Arrangements

We do not have any transactions, arrangements and other relationships with unconsolidated entities that will affect our liquidity or capital resources. We have no special purpose entities that provided off-balance sheet financing, liquidity or market or credit risk support, nor do we engage in leasing, swap agreements, or outsource of research and development services, that could expose us to liability that is not reflected on the face of our financial statements.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

The Company's exposure to financial market risk results primarily from fluctuations in interest and currency rates. There have been no material changes to our market risks as disclosed in our Annual Report on Form 10-K for the year ended December 31, 2005.

Item 4. Controls and Procedures

Our Chief Executive Officer, Keh-Shew Lu, and Chief Financial Officer, Carl C. Wertz, with the participation of the Company's management, carried out an evaluation of the effectiveness of our disclosure controls and procedures pursuant to Exchange Act Rule 13a-15(e). Based upon that evaluation, the Chief Executive Officer and the Chief Financial Officer believe that, as of the end of the period covered by this report, our disclosure controls and procedures are effective at the reasonable assurance level in making known to them material information relating to us (including our consolidated subsidiaries) required to be included in this report.

Disclosure controls and procedures, no matter how well designed and implemented, can provide only reasonable assurance of achieving an entity's disclosure objectives. The likelihood of achieving such objectives is affected by limitations inherent in disclosure controls and procedures. These include the fact that human judgment in decision-making can be faulty and that breakdowns in internal control can occur because of human failures such as simple errors, mistakes or intentional circumvention of the established processes.

There was no change in our internal control over financial reporting, known to the Chief Executive Officer or the Chief Financial Officer that occurred during the period covered by this report that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II - OTHER INFORMATION

Item 1. Legal Proceedings

The Company is, from time to time, involved in litigation incidental to the conduct of its business. The Company does not believe it is currently a party to any pending litigation.

Item 1A. Risk Factors

Other than with respect to the risk factors below, there have been no material changes from the risk factors disclosed in the “Risk Factors” section of our Annual Report on Form 10-K for the fiscal year ended December 31, 2005, filed on March 15, 2006.

The following risk factors are new risk factors compared to the risk factors in our Annual Report on Form 10-K:

We currently have a significant amount of debt following our convertible senior notes offering. Our substantial indebtedness could adversely affect our business, financial condition and results of operations and our ability to meet our payment obligations under the notes and our other debt.

Following our offering of \$230.0 million of senior convertible notes in October, 2006, we currently have a significant amount of debt and substantial debt service requirements. In addition to the debt from our note offering, we have \$20.0 million available for future borrowings under our senior secured credit facility, and we are permitted under the terms of our debt agreements to incur substantial additional debt.

This level of debt could have significant consequences on our future operations, including:

- 1 making it more difficult for us to meet our payment and other obligations under the notes and our other outstanding debt;
- 1 resulting in an event of default if we fail to comply with the financial and other restrictive covenants contained in our debt agreements, which event of default could result in all of our debt becoming immediately due and payable and, in the case of an event of default under our secured debt, such as our senior secured credit facility, could permit the lenders to foreclose on our assets securing that debt;
- 1 reducing the availability of our cash flow to fund working capital, capital expenditures, acquisitions and other general corporate purposes, and limiting our ability to obtain additional financing for these purposes;
- 1 subjecting us to the risk of increased sensitivity to interest rate increases on our indebtedness with variable interest rates, including borrowings under our senior secured credit facility;
- 1 limiting our flexibility in planning for, or reacting to, and increasing our vulnerability to, changes in our business, the industry in which we operate and the general economy; and
- 1 placing us at a competitive disadvantage compared to our competitors that have less debt or are less leveraged.

Any of the above-listed factors could have an adverse effect on our business, financial condition and results of operations and our ability to meet our payment obligations under the notes and our other debt.

Conversion of our convertible senior notes will dilute the ownership interest of existing shareholders, including holders who had previously converted their notes.

To the extent we issue common stock upon conversion of the notes, the conversion of some or all of the notes will dilute the ownership interests of existing shareholders, including holders who have received common stock upon prior conversion of the notes. Any sales in the public market of the common stock issuable upon such conversion could

adversely affect prevailing market prices of our common stock. In addition, the existence of the notes may encourage short selling by market participants because the conversion of the notes could depress the price of our common stock.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

There are no matters to be reported under this heading.

Item 3. Defaults Upon Senior Securities

There are no matters to be reported under this heading.

Item 4. Submission of Matters to a Vote of Security Holders

There are no matters to be reported under this heading.

Item 5. Other Information

There are no matters to be reported under this heading.

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Item 6. Exhibits

- 3.1 Certificate of Incorporation, as amended (incorporated by reference to Exhibit 3.1 of Amendment No. 1 to the Company's Registration Statement on Form S-3 (File No. 333-127833) filed on September 8, 2005).
- 3.2 Amended Bylaws of the Company dated August 14, 1987 (incorporated by reference to Exhibit 3 to Form 10-K filed with the Commission for fiscal year ended April 30, 1988).
- 11 Computation of Earnings Per Share
- 31.1 Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 31.2 Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 32.1 Certification Pursuant to 18 U.S.C. 1350 Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 32.2 Certification Pursuant to 18 U.S.C. 1350 Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

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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.

DIODES INCORPORATED (Registrant)

By: /s/ Carl C. Wertz

November 8, 2006

CARL C. WERTZ
Chief Financial Officer, Treasurer and
Secretary
(Duly Authorized Officer and Principal
Financial and
Chief Accounting Officer)

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