HARMONIC INC
Form 10-Q
November 08, 2006

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

FORM 10-Q

(Mark One)

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

For the Quarterly Period Ended September 29, 2006

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

Commission File No. 0-25826
HARMONIC INC.
(Exact name of Registrant as specified in its charter)

Delaware	**77-0201147**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification Number)**

549 Baltic Way
Sunnyvale, CA 94089
(408) 542-2500
(Address, including zip code, and telephone number, including area code, of Registrant s principal executive offices)

Securities registered pursuant to section 12(b) of the Act:
None
Securities registered pursuant to section 12(g) of the Act:
Common Stock, par value $.001 per share
Preferred Share Purchase Rights

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 shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes þ **No** o

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer (as defined in Rule 12b-2 of the Exchange Act). (Check one):

Large accelerated filer o **Accelerated filer** þ **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** þ

The number of shares outstanding of the Registrant s Common Stock, $.001 par value, was 74,681,986 on October 27, 2006.

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PART I

FINANCIAL INFORMATION

Item 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

HARMONIC INC.

CONDENSED CONSOLIDATED BALANCE SHEETS (UNAUDITED)

(In thousands, except par value amounts)	September 29, 2006	December 31, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 50,404	$ 37,818
Short-term investments	60,320	73,010
Accounts receivable, net of allowances of $4,015 and $3,230	52,423	43,433
Inventories	35,635	38,552
Prepaid expenses and other current assets	16,104	8,335
Total current assets	214,886	201,148
Property and equipment, net	14,943	17,040
Intangibles and other assets	7,238	8,109
Total assets	$ 237,067	$ 226,297
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Current portion of long-term debt	$ 596	$ 812
Accounts payable	22,864	19,378
Income taxes payable	6,952	6,480
Deferred revenue	23,019	18,932
Accrued liabilities	40,990	37,438
Total current liabilities	94,421	83,040
Long-term debt, less current portion	61	460
Accrued excess facilities costs, long-term	17,889	18,357
Other non-current liabilities	7,020	11,458
Total liabilities	119,391	113,315
Commitments and contingencies (Notes 15 and 16)		
Stockholders equity:		
Preferred stock, $0.001 par value, 5,000 shares authorized; no shares issued or outstanding		
Common stock, $0.001 par value, 150,000 shares authorized; 74,645 and 73,636 shares issued and outstanding	75	74
Capital in excess of par value	2,056,519	2,048,090
Accumulated deficit	(1,938,750)	(1,934,715)
Accumulated other comprehensive loss	(168)	(467)
Total stockholders equity	117,676	112,982

Total liabilities and stockholders equity	$	237,067	$	226,297

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

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HARMONIC INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(UNAUDITED)

(In thousands, except per share amounts)	Three Months Ended September 29, 2006	Three Months Ended September 30, 2005	Nine Months Ended September 29, 2006	Nine Months Ended September 30, 2005
Net sales	$ 62,856	$ 60,960	$ 172,346	$ 193,638
Cost of sales	33,059	39,564	101,064	121,797
Gross profit	29,797	21,396	71,282	71,841
Operating expenses:				
Research and development	10,021	9,403	29,554	28,381
Selling, general and administrative	16,931	15,166	48,623	47,102
Amortization of intangibles	45	110	179	1,233
Total operating expenses	26,997	24,679	78,356	76,716
Income (loss) from operations	2,800	(3,283)	(7,074)	(4,875)
Interest income, net	1,182	669	3,349	1,828
Other income (expense), net	137	(288)	173	(643)
Income (loss) before income taxes	4,119	(2,902)	(3,552)	(3,690)
Provision for (benefit from) income taxes	103	(11)	482	25
Net income (loss)	$ 4,016	$ (2,891)	$ (4,034)	$ (3,715)
Net income (loss) per share basic	$ 0.05	$ (0.04)	$ (0.05)	$ (0.05)
Net income (loss) per share diluted	$ 0.05	$ (0.04)	$ (0.05)	$ (0.05)
Weighted average shares basic	74,588	73,554	74,286	73,168
Weighted average shares diluted	75,050	73,554	74,286	73,168

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

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HARMONIC INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

(In thousands)	**Nine Months Ended September 29, 2006**	**Nine Months Ended September 30, 2005**
Cash flows from operating activities:		
Net loss	$ (4,034)	$ (3,715)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Amortization of intangibles	672	2,311
Depreciation	5,719	6,278
Stock-based compensation	4,376	9
Loss on disposal of fixed assets	55	15
Deferred income taxes		(282)
Changes in assets and liabilities, net of effect of acquisition:		
Accounts receivable	(9,314)	16,774
Inventories	2,877	22
Prepaid expenses and other assets	(8,133)	2,275
Accounts payable	3,486	(2,727)
Deferred revenue	2,474	4,774
Income taxes payable	366	(706)
Accrued excess facilities costs	683	(3,530)
Accrued and other liabilities	764	(12,475)
Net cash provided by (used in) operating activities	(9)	9,023
Cash flows from investing activities:		
Purchases of investments	(58,061)	(47,202)
Proceeds from sales of investments	71,030	49,053
Acquisition of property and equipment	(3,677)	(4,232)
Acquisition of BTL, net of cash received		(5,955)
Net cash provided by (used in) investing activities	9,292	(8,336)
Cash flows from financing activities:		
Proceeds from issuance of common stock	4,017	6,281
Repayments under bank line and term loan	(615)	(829)
Repayments of capital lease obligations	(61)	(72)
Net cash provided by financing activities	3,341	5,380
Effect of exchange rate changes on cash and cash equivalents	(38)	134
Net increase in cash and cash equivalents	12,586	6,201
Cash and cash equivalents at beginning of period	37,818	26,603
Cash and cash equivalents at end of period	$ 50,404	$ 32,804

Supplemental disclosure of cash flow information:				
Income tax payments, net	$	177	$	118
Interest paid during the period	$	94	$	269
Non-cash investing and financing activities:				
Issuance of restricted common stock for BTL acquisition	$		$	1,831

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

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HARMONIC INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Note 1: Basis of Presentation

The accompanying unaudited condensed consolidated financial statements include all adjustments (consisting only of normal recurring adjustments) which Harmonic Inc. (the Company) considers necessary for a fair statement of the results of operations for the interim periods covered and the consolidated financial condition of the Company at the date of the balance sheets. This Quarterly Report on Form 10-Q should be read in conjunction with the Company s audited consolidated financial statements contained in the Company s Annual Report on Form 10-K/A, which was filed with the Securities and Exchange Commission on April 26, 2006. The interim results presented herein are not necessarily indicative of the results of operations that may be expected for the full fiscal year ending December 31, 2006, or any other future period. The Company s fiscal quarters end on the Friday nearest the calendar quarter end, except for the fourth quarter which ends on December 31.

The condensed consolidated financial statements include the accounts of the Company and its subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

Certain amounts in the prior year s financial statements and related notes have been reclassified to conform to the 2006 presentation. These reclassifications have no material impact on previously reported net loss or cash flows.

Use of Estimates

The preparation of the consolidated financial statements in conformity with generally accepted accounting principles 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 revenue and expenses during the reporting period. Actual results could differ from those estimates.

Note 2: Recent Accounting Pronouncements

In March 2006, the Emerging Issues Task Force reached a consensus on Issue No. 06-03, How Taxes Collected from Customers and Remitted to Government Authorities Should Be Presented in the Income Statement (That Is, Gross versus Net Presentation) (EITF No. 06-03). The Company is required to adopt the provisions of EITF No. 06-03 beginning in fiscal year 2007. The Company does not expect the provisions of EITF No. 06-03 to have a material impact on the Company s consolidated financial position, results of operations or cash flows.

In June 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109 (FIN 48). FIN 48 prescribes a comprehensive model for how a company should recognize, measure, present, and disclose in its financial statements uncertain tax positions that the company has taken or expects to take on a tax return. FIN 48 will be effective for fiscal years beginning after December 15, 2006. We are currently in the process of evaluating the effect, if any, FIN 48 will have on our consolidated financial statements.

In September 2006, the Securities and Exchange Commission 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 guidance on how prior year misstatements should be taken into consideration when quantifying misstatements in current year financial statements for purposes of determining whether the current year s financial statements are materially misstated. SAB 108 becomes effective during our 2007 fiscal year. We do not expect the adoption of SAB 108 to have a material impact on our financial statements.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, Fair Value Measurements (SFAS No. 157). This statement clarifies the definition of fair value, establishes a framework for measuring fair value, and expands the disclosures on fair value measurements. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007. We have not determined the effect, if any, the adoption of this statement will have on our results of operations or financial position.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 106, and 132(R) (SFAS No. 158). SFAS No. 158 requires companies to recognize a net liability or asset and an offsetting adjustment to accumulated other comprehensive income to report the funded status of defined benefit pension and other postretirement benefit plans. SFAS No. 158 requires prospective application, and the recognition and disclosure requirements are effective for the Company s fiscal year ending December 31, 2007. Additionally, SFAS No. 158 requires companies to measure plan assets and obligations at their year-end balance sheet date. This requirement is effective for fiscal years ending after December 15, 2008. We do not expect the adoption of SFAS No. 158 to have a material impact on our financial statements.

Note 3: Stock-based Compensation

On January 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123(R), Share-Based Payment, (SFAS 123(R)) which requires the measurement and recognition of compensation expense for all share-based payment awards made to employees and directors, including employee stock options and employee stock purchases related to our Employee Stock Purchase Plan (ESPP) based upon the grant-date fair value of those awards. SFAS 123(R) supersedes the Company s previous accounting under Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB 25) and related interpretations, and provided the required pro forma disclosures prescribed by Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation, (SFAS 123) as amended. In addition, we have applied the provisions of Staff Accounting Bulletin No. 107 (SAB 107), issued by the Securities and Exchange Commission, in our adoption of SFAS No. 123(R).

The Company adopted SFAS 123(R) using the modified-prospective transition method, which requires the application of the accounting standard as of January 1, 2006, the first day of the Company s fiscal year 2006. The Company s Condensed Consolidated Financial Statements as of and for the three and nine months ended September 29, 2006 reflect the impact of SFAS 123(R). In accordance with the modified prospective transition method, the Company s Condensed Consolidated Financial Statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS 123(R). Stock-based compensation expense recognized under SFAS 123(R) for the three and nine months ended September 29, 2006 was $1.2 million and $4.4 million, respectively, which consisted of stock-based compensation expense related to employee equity awards and employee stock purchases. There was no stock-based compensation expense related to employee equity awards and employee stock purchases recognized during the three and nine months ended September 30, 2005.

SFAS 123(R) requires companies to estimate the fair value of share-based payment awards on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as expense over the requisite service period in the Company s Condensed Consolidated Statement of Operations. Prior to the adoption of SFAS 123(R), the Company accounted for employee equity awards and employee stock purchases using the intrinsic value method in accordance with APB 25 as allowed under SFAS 123. Under the intrinsic value method, no stock-based compensation expense had been recognized in the Company s Condensed Consolidated Statement of Operations because the exercise price of the Company s stock options granted to employees and directors equaled the fair market value of the underlying stock at the date of grant.

Stock-based compensation expense recognized during the period is based on the value of the portion of share-based payment awards that is ultimately expected to vest during the period. Stock-based compensation expense recognized in the Company s Condensed Consolidated Statement of Operations for the three and nine months ended September 29, 2006 included compensation expense for share-based payment awards granted prior to, but not yet vested as of December 31, 2005 based on the grant date fair value estimated in accordance with the pro forma provisions of SFAS 123 and compensation expense for the share-based payment awards granted subsequent to December 31, 2005 based on the grant date fair value estimated in accordance with the provisions of SFAS 123(R). In conjunction with the adoption of SFAS 123(R), the Company changed its method of attributing the value of stock-based compensation costs to expense from the accelerated multiple-option method to the straight-line single-option method. Compensation expense for all share-based payment awards granted on or prior to December 31, 2005 will

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continue to be recognized using the accelerated approach while compensation expense for all share-based payment awards related to stock options and employee stock purchase rights granted subsequent to December 31, 2005 are recognized using the straight-line method.

As stock-based compensation expense recognized in our results for the three and nine months ended September 29, 2006 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Prior to fiscal year 2006, we accounted for forfeitures as they occurred for the purposes of pro forma information under SFAS 123, as disclosed in our Notes to Consolidated Financial Statements for the related periods.

The fair value of share-based payment awards is estimated at grant date using a Black-Scholes-Merton option pricing model. The Company s determination of fair value of share-based payment awards on the date of grant using an option-pricing model is affected by the Company s stock price as well as the assumptions regarding a number of highly complex and subjective variables. These variables include, but are not limited to, the Company s expected stock price volatility over the term of the awards, and actual and projected employee stock option exercise behaviors.

Harmonic currently does not expect to receive any tax benefits in fiscal 2006 for any expense deductions resulting from expensing of stock options or shares issued under its ESPP plan. On November 10, 2005 the FASB issued FASB Staff Position No. FSP FAS 123(R)-3, *Transition Election Related to Accounting for Tax Effects of Share-Based Payment Awards*. Harmonic currently provides a valuation allowance for most of its deferred tax assets, and a valuation allowance has also been provided for deferred tax assets related to nonqualified stock options.

Also see Note 10 for further discussion of stock-based compensation.

Note 4: BTL Acquisition

On February 25, 2005, Harmonic purchased all of the issued and outstanding shares of Broadcast Technology Limited, or BTL, a private UK company, for a purchase consideration of £4.0 million, or approximately $7.6 million. The purchase consideration consisted of a payment of £3.0 million in cash and the issuance of 169,112 shares of Harmonic common stock. In addition, Harmonic paid approximately $0.3 million in transaction costs for a total transaction price of approximately $7.9 million. The addition of BTL has expanded Harmonic s product line to include professional video/audio receivers and decoders. This enabled us to expand the scope of solutions we provide for existing and emerging cable, satellite, terrestrial broadcast and telecom applications. These factors contributed to a purchase price exceeding the fair value of BTL s net tangible and intangible assets acquired; as a result, we have recorded goodwill in connection with this transaction.

The BTL acquisition was accounted for under SFAS No. 141 and certain specified provisions of SFAS No. 142. The results of operations of BTL are included in Harmonic s Condensed Consolidated Statements of Operations from February 25, 2005, the date of acquisition. The following table summarizes the allocation of the purchase price based on the estimated fair value of the tangible assets acquired and the liabilities assumed at the date of acquisition (in thousands):

Cash acquired	$ 149
Other tangible assets acquired	2,508
Amortizable intangible assets:	
Existing technology	2,050
Customer relationships	540
Tradenames/trademarks	320
Order backlog	60
Goodwill	3,745
Total assets acquired	9,372
Liabilities assumed	(568)
Deferred tax liability for acquired intangibles	(891)

Net assets acquired	$ 7,913

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Identified intangible assets, including existing technology and customer relationships are being amortized over their useful lives of three years; tradename/trademarks are being amortized over their useful lives of two years; and order backlog was amortized over its useful life of three months.

The residual purchase price of $3.7 million has been recorded as goodwill. The goodwill as a result of this acquisition is not expected to be deductible for tax purposes. In accordance with SFAS No. 142, Goodwill and Other Intangible Assets, goodwill relating to the acquisition of BTL is not being amortized and will be tested for impairment annually or whenever events indicate that an impairment may have occurred.

Supplemental pro forma information is not provided because the acquisition of BTL was not material to the Company s financial statements for all periods presented.

Note 5: Cash, Cash Equivalents and Investments

At September 29, 2006 and December 31, 2005, cash, cash equivalents and short-term investments are summarized as follows (in thousands):

	September 29, 2006	December 31, 2005
Cash and cash equivalents	$ 50,404	$ 37,818
Short-term investments:		
Less than one year	57,326	56,605
Due in 1-2 years	2,994	16,405
Total short-term investments	60,320	73,010
Total cash, cash equivalents and short-term investments	$ 110,724	$ 110,828

The following is a summary of available-for-sale securities (in thousands).

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
September 29, 2006				
U.S. government debt securities	$ 21,992	$ 20	$ (65)	$ 21,947
Corporate debt securities	36,826	26	(54)	36,798
Other debt securities	1,575			1,575
Total	$ 60,393	$ 46	$ (119)	$ 60,320
December 31, 2005				
U.S. government debt securities	$ 20,264	$	$ (146)	$ 20,118
Corporate debt securities	46,873	3	(209)	46,667
Other debt securities	6,225			6,225
Total	$ 73,362	$ 3	$ (355)	$ 73,010

Impairment of Investments

We monitor our investment portfolio for impairment on a periodic basis. In the event that the carrying value of an investment exceeds its fair value and the decline in value is determined to be other-than-temporary, an impairment charge is recorded and a new cost basis for the investment is established. In order to determine whether a decline in value is other-than-temporary, we evaluate, among other factors: the duration and extent to which the fair value has been less than the carrying value; our financial condition and business outlook, including key operational and cash flow metrics, current market conditions and future trends in the company s industry; our relative competitive position within the industry; and our intent and ability to retain the investment for a period of time sufficient to allow any anticipated recovery in fair value.

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In accordance with FASB Staff Position Nos. 115-1 and FAS 124-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments (FSP FAS 115-1), the following table summarizes the fair value and gross unrealized losses related to available-for-sale securities, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, as of September 29, 2006 (in thousands):

	Less than 12 months		Greater than 12 months		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
U.S. Government debt securities	$ 8,206	$ (43)	$ 8,260	$ (22)	$ 16,466	$ (65)
Corporate debt securities	8,293	(33)	14,010	(20)	22,303	(53)
Total	$ 16,499	$ (76)	$ 22,270	$ (42)	$ 38,769	$ (118)

The decline in the estimated fair value of these investments relative to amortized cost is primarily related to changes in interest rates and is considered to be temporary in nature.

Note 6: Inventories

(In thousands)	**September 29, 2006**	**December 31, 2005**
Raw materials	$ 11,690	$ 14,392
Work-in-process	2,881	4,131
Finished goods	21,064	20,029
	$ 35,635	$ 38,552

Note 7: Goodwill and Identified Intangibles

The following is a summary of goodwill and intangible assets as of September 29, 2006 and December 31, 2005 (in thousands):

	September 29, 2006			December 31, 2005		
	Gross Carrying Amount *	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount *	Accumulated Amortization	Net Carrying Amount
Identified intangibles:						
Developed core technology	$ 29,839	$ (28,875)	$ 964	$ 29,663	$ (28,315)	$ 1,348
Customer base	31,909	(31,909)		31,904	(31,904)	
Trademark and tradename	4,218	(4,218)		4,190	(4,142)	48
Supply agreement	3,510	(3,256)	254	3,464	(3,109)	355
Subtotal of identified intangibles	69,476	(68,258)	1,218	69,221	(67,470)	1,751
Goodwill	4,614		4,614	4,896		4,896

Total goodwill and other intangibles	$ 74,090	$ (68,258)	$ 5,832	$ 74,117	$ (67,470)	$ 6,647

* Foreign currency translation adjustments, reflecting movement in the currencies of the underlying entities, totaled approximately $0.1 and $0.3 million for intangible assets and approximately $0.3 and $0.3 million for goodwill as of September 29, 2006 and December 31, 2005, respectively.

The changes in the carrying amount of goodwill for the nine months ended September 29, 2006 are as follows (in thousands):

	Goodwill
Balance as of January 1, 2006	$ 4,896
Purchase price adjustments*	(531)
Foreign currency translation adjustments	249
Balance as of September 29, 2006	$ 4,614

* Purchase price adjustments that affect existing goodwill were due to deferred taxes.

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For the three and nine months ended September 29, 2006, the Company recorded a total of $0.2 million and $0.7 million, of amortization expense for identified intangibles, of which $0.2 million and $0.5 million, was included in cost of sales, respectively. For the three and nine months ended September 30, 2005, the Company recorded a total of $0.3 and $2.3 million of amortization expense for identified intangibles, of which $0.2 million and $1.1 million was included in cost of sales, respectively. The estimated future amortization expense of purchased intangible assets with definite lives for the next three years is as follows (in thousands):

Years Ending December 31,	**Amounts**
2006 (remaining 3 months)	$ 215
2007	860
2008	143
Total	$ 1,218

Note 8: Restructuring and Excess Facilities

During 2001, Harmonic recorded a charge for excess facilities costs of $21.8 million. As a result of uncertain market conditions and lower sales during the second half of 2002, the Company changed its estimates related to accrued excess facilities with regard to the expected timing and amount of sublease income due to the substantial surplus of vacant commercial space in the San Francisco Bay Area. In connection with these actions, Harmonic recorded an additional excess facilities charge of $22.5 million, net of sublease income, to selling, general and administrative expenses during the second half of 2002.

As of September 29, 2006, accrued excess facilities cost totaled $24.3 million of which $6.4 million was included in current accrued liabilities and $17.9 million in other non-current liabilities. The Company incurred cash outlays of $3.5 million during the first nine months of 2006 principally for lease payments, property taxes, insurance and other maintenance fees related to vacated facilities. Harmonic expects to pay approximately $1.7 million of excess facility lease costs, net of estimated sublease income, for the remainder of 2006 and to pay the remaining $22.6 million, net of estimated sublease income, over the remaining lease terms through September 2010.

Harmonic reassesses this liability quarterly and adjusts as necessary based on changes in the timing and amounts of expected sublease rental income. In the fourth quarter of 2005 the excess facilities liability was decreased by $1.1 million due to subleasing a portion of an unoccupied building for the remainder of the lease.

During the fourth quarter of 2005, in response to the consolidation of the Company s two operating segments into a single segment as of January 1, 2006, the Company implemented workforce reductions of approximately 40 full-time employees across all functions and primarily in our U.S. operations and recorded severance and other costs of approximately $1.1 million. No liability remains as of September 29, 2006.

During the second quarter of 2006, the Company streamlined its senior management team primarily in the U.S. operations and recorded severance and other costs of approximately $1.0 million. We expect the remaining payments related to these actions to be paid by the end of the second quarter of 2007.

During the third quarter of 2006, the Company recorded a net charge in selling, general and administrative expenses for excess facilities of $2.1 million. The Company recorded a charge of $3.8 million, net of estimated sublease income, in accordance with the provisions of FAS No. 146 Accounting for Costs Associated with Exit or Disposal Activities for two buildings which were vacated during the third quarter in connection with a plan to make more efficient use of our Sunnyvale campus. The $5.9 million accrued excess facility costs for these buildings also includes the reclassification of a deferred rent liability of $2.1 million. In addition, during the third quarter of 2006, the Company recorded a benefit of $1.7 million as a result of a revision to estimates of projected sublease income on entering into sublease agreements for certain buildings previously exited under EITF 94-3 Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring). This benefit partially offsets the charge recorded by the Company in the third quarter of 2006 from the consolidation of its Sunnyvale campus.

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The following table summarizes restructuring activities (in thousands):

	Workforce Reduction	Management Reduction	Excess Facilities	Campus Consolidation	Total
Balance at December 31, 2005	$ 635	$	$ 23,576	$	$ 24,211
Provisions/(recoveries)	(25)	962	(1,743)	5,947	5,141
Cash payments, net of sublease income	(610)	(451)	(3,521)		(4,582)
Balance at September 29, 2006	$	$ 511	$ 18,312	$ 5,947	$ 24,770

Note 9: Credit Facilities and Long-Term Debt

Harmonic has a bank line of credit facility with Silicon Valley Bank, which provides for borrowings of up to $23.7 million, including $3.7 million for equipment under a secured term loan. This facility, which was amended and restated in December 2005, expires in December 2006, and contains financial and other covenants including the requirement for Harmonic to maintain cash, cash equivalents and short-term investments, net of credit extensions, of not less than $30.0 million. If Harmonic is unable to maintain this cash, cash equivalents and short-term investments balance or satisfy the additional affirmative covenant requirements, Harmonic would be in noncompliance with the facility. In the event of noncompliance by Harmonic with the covenants under the facility, Silicon Valley Bank would be entitled to exercise its remedies under the facility which include declaring all obligations immediately due and payable and disposing of the collateral if obligations were not repaid. At September 29, 2006, Harmonic was in compliance with the covenants under this line of credit facility. The December 2005 amendment resulted in the company paying a fee of approximately $33,000 and requiring payment of approximately $43,000 of additional fees if the company does not maintain an unrestricted deposit of $20.0 million with the bank. Future borrowings pursuant to the line bear interest at the bank s prime rate (8.25% at September 29, 2006) or prime plus 0.5% for equipment borrowings. Borrowings are payable monthly and are collateralized by all of Harmonic s assets except intellectual property. As of September 29, 2006, $0.7 million was outstanding under the equipment term loan portion of this facility and there were no additional borrowings in 2005 or 2006. The term loan is repayable monthly, including principal and interest at 8.75% per annum on outstanding borrowings as of September 29, 2006 and matures at various dates through December 2007. Other than standby letters of credit and guarantees (Note 15), there were no other outstanding borrowings or commitments under the line of credit facility as of September 29, 2006.

Note 10: Benefit Plans

Stock Option Plans. Harmonic has reserved 12,329,000 shares of Common Stock for issuance under various employee stock option plans. The options are granted for periods not exceeding ten years and generally vest 25% at one year from date of grant, and an additional 1/48 of such grant per month thereafter. Stock options are granted at the fair market value of the stock at the date of grant. Beginning on February 27, 2006, option grants have a term of seven years. Certain option awards provide for accelerated vesting if there is a change in control.

Director Option Plans. In May 2002, Harmonic s stockholders approved the 2002 Director Option Plan (the Plan), replacing the 1995 Director Option Plan. In June 2006, Harmonic s stockholders approved an amendment to the Plan and increased the maximum number of shares of common stock authorized for issuance over the term of the Plan by an additional 300,000 shares to 700,000 shares and reduced the term of future options granted under the Plan to seven years. Harmonic has a total of 728,000 shares of Common Stock reserved for issuance under the Director Plans. The Plan provides for the grant of non-statutory stock options to certain non-employee directors of Harmonic pursuant to an automatic, non-discretionary grant mechanism. Options are granted at the fair market value of the stock at the date of grant for periods not exceeding seven years. Initial grants generally vest monthly over three years, and subsequent grants generally vest monthly over one year.

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The following table summarizes activities under the Plans:

	Shares Available for Grant	Stock Options Outstanding	Weighted Average Exercise Price	
	(In thousands except exercise price)			
Balance at December 31, 2005	3,984	9,064	$	13.05
Shares authorized	300			
Options granted	(1,947)	1,947		5.64
Options exercised		(197)		3.73
Options canceled	1,462	(1,462)		11.41
Options expired		(94)		43.99
Balance at September 29, 2006	3,799	9,258		11.64
Options vested and exercisable as of September 29, 2006		6,297		11.90
Options vested and expected-to-vest as of September 29, 2006		8,859	$	14.27

The weighted-average fair value of options granted for the nine months ended September 29, 2006 was $3.62.
The following table summarizes information regarding stock options outstanding at September 29, 2006:

Range of Exercise Prices		Stock Options Outstanding: Number Outstanding at September 29, 2006	Weighted-Average Remaining Contractual Life (Years)	Weighted-Average Exercise Price		Stock Options Exercisable: Number Exercisable at September 29, 2006	Weighted Average Exercise Price	
		(In thousands, except exercise price and life)						
$ 1.75	5.56	1,403	6.3	$	3.90	866	$	3.50
5.62	5.87	2,317	7.2		5.86	367		5.84
5.88	8.93	1,450	5.9		8.02	1,122		7.99
9.00	9.29	1,156	5.2		9.17	1,039		9.16
9.53	13.82	1,262	4.7		10.64	1,233		10.64
14.50	25.17	988	3.6		22.96	988		22.96
25.50	121.68	682	3.1		44.57	682		44.57
		9,258	5.6	$	11.64	6,297	$	14.27

The weighted-average remaining contractual life for all exercisable stock options at September 29, 2006 was 4.9 years. The weighted-average remaining contractual life of all vested and expected-to-vest stock options at September 29, 2006 was 5.5 years.

Aggregate pre-tax intrinsic value of options outstanding and exercisable at September 29, 2006 was $8.8 million and $4.2 million, respectively. The aggregate intrinsic value of stock options vested and expected-to-vest net of estimated forfeitures was $8.2 million at September 29, 2006. Aggregate pre-tax intrinsic value represents the difference between our closing price on the last trading day of the fiscal period, which was $7.36 as of September 29, 2006, and the exercise price multiplied by the applicable number of options. The intrinsic value of exercised stock options is calculated based on the difference between the exercise price and the quoted market price of our common stock as of the close of the exercise date. The aggregate intrinsic value of exercised stock options was $0.1million and $0.3 million during the three and nine months ended September 29, 2006, respectively.

Employee Stock Purchase Plan.

In May 2002, Harmonic s stockholders approved the 2002 Employee Stock Purchase Plan (the 2002 Purchase Plan) replacing the 1995 Employee Stock Purchase Plan effective for the offering period beginning on July 1, 2002. In May 2004, Harmonic s stockholders approved an amendment to the 2002 Purchase Plan and increased the maximum number of shares of common stock authorized for issuance over the term of the 2002 Purchase Plan by an additional 2,000,000 shares. In June 2006, Harmonic s stockholders approved an amendment to the 2002 Purchase Plan to increase the maximum number of shares of common stock available for issuance under the 2002 Purchase Plan by an additional 2,000,000 shares to 5,500,000 shares and reduce the term of future offering periods to six months. The 2002 Purchase Plan enables employees to purchase shares at 85% of the fair market value of the

Common Stock at the beginning of the offering period or end of the purchase period, whichever is lower. Prior to the approval of the June 2006 amendment, each offering period had a maximum duration of two years and consisted of four six-month purchase periods. Offering periods and purchase periods generally began on the first trading day on or after January 1 and July 1 of each year. The 2002 Purchase Plan is intended to qualify as an employee stock purchase plan under Section 423 of the Internal Revenue Code. During the first nine months of 2006 and the years 2005 and 2004, the number of shares of stock issued under the purchase plans were 811,565; 705,171 and 774,683 shares at weighted average prices of $4.04, $5.05 and $2.32, respectively. The weighted-average fair value of each right to purchase shares of common stock granted under the purchase plans were $1.44, $1.82 and $2.68 for the first nine months of 2006 and the years 2005 and 2004, respectively. At September 29, 2006, there were 2,483,495 shares reserved for future issuances under the 2002 Purchase Plan.

Retirement/Savings Plan. Harmonic has a retirement/savings plan which qualifies as a thrift plan under Section 401(k) of the Internal Revenue Code. This plan allows participants to contribute up to 20% of total compensation, subject to applicable Internal Revenue Service limitations. Harmonic makes discretionary contributions to the plan of 25% of the first 4% contributed by eligible participants up to a maximum contribution per participant of $750 per year. This amount has been increased to $1,000 effective January 1, 2006. Such amounts totaled $0.1 million and $0.3 million in the third quarter and first nine months of 2006, respectively.

Stock-based Compensation

The following table summarizes the impact of options from SFAS 123(R) on stock-based compensation costs for employees on our Condensed Consolidated Statements of Operations for the three and nine months ended September 29, 2006 and September 30, 2005:

(In thousands)	**Three Months Ended September 29, 2006**	**Nine Months Ended September 29, 2006**
Employee stock-based compensation in:		
Cost of sales	$ 184	$ 727
Research and development expense	331	1,304
Sales, general and administrative expense	729	2,342
Total employee stock-based compensation in operating expense	1,060	3,646
Total employee stock-based compensation	1,244	4,373
Amount capitalized in inventory	38	38
Total other stock-based compensation (1)		2
Total stock-based compensation	$ 1,282	$ 4,413

(1) Other stock-based compensation represents charges related to non-employee

stock options.

As of September 29, 2006, total unamortized stock-based compensation cost related to unvested stock options was $6.9 million, with the weighted average recognition period of 1.4 years.

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The table below reflects net loss and net loss per share, and pro forma information for the three and nine months ended September 30, 2005 (in thousands, except per share amounts):

	Three Months Ended September 30, 2005 (pro forma)	Nine Months Ended September 30, 2005 (pro forma)
Net loss, before stock-based compensation for employees, prior period	$ (2,891)	$ (3,715)
Less: Stock-based compensation expense previously determined under fair value based method, net of related tax effects	(2,594)	(6,740)
Net loss, after effect of stock-based compensation for employees	$ (5,485)	$ (10,455)
Net loss per share:		
Basic as reported for prior period	$ (0.04)	$ (0.05)
Basic after effect of stock-based compensation for employees	$ (0.07)	$ (0.14)
Diluted as reported for prior period	$ (0.04)	$ (0.05)
Diluted after effect of stock-based compensation for employees	$ (0.07)	$ (0.14)

The fair value of each option grant is estimated on the date of grant using the Black-Scholes-Merton multiple option pricing model with the following weighted average assumptions:

	Employee Stock Options			
	Three Months Ended		Nine Months Ended	
	September 29, 2006	September 30, 2005	September 29, 2006	September 30, 2005
Expected life (years)	4.75	3.2	4.75	3.7
Volatility	69%	91%	76%	96%
Risk-free interest rate	4.9%	3.8%	4.6%	3.8%
Dividend yield	0.0%	0.0%	0.0%	0.0%

	Employee Stock Purchase Plan			
	Three Months Ended		Nine Months Ended	
	September 29, 2006	September 30, 2005	September 29, 2006	September 30, 2005
Expected life (years)	0.5	0.8	0.5	0.8
Volatility	56%	61%	56%	69%
Risk-free interest rate	5.07%	3.7%	5.07%	3.7%

Dividend yield	0.0%	0.0%	0.0%	0.0%

The expected term for employee stock options and the ESPP represents the weighted-average period that the stock options are expected to remain outstanding. We derived the expected term using the SAB 107 simplified method. As alternative sources of data become available in order to determine the expected term we will incorporate these data into our assumption.

We use the historical volatility over the expected term of the options and the ESPP offering period to estimate the expected volatility. We believe that the historical volatility, at this time, represents fairly the future volatility of its common stock. We will continue to monitor relevant information to measure expected volatility for future option grants and ESPP offering periods.

The risk-free interest rate assumption is based upon observed interest rates appropriate for the term of our employee stock options. The dividend yield assumption is based on our history and expectation of dividend payouts.

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Note 11: Net Income (Loss) Per Share

Basic net income (loss) per share is computed by dividing the net income (loss) attributable to common stockholders for the period by the weighted average number of the common shares outstanding during the period. Diluted net income per share is computed by dividing the net income (loss) for the period by the weighted average number of common shares and potential common shares outstanding during the period if their effect is dilutive. The diluted net loss per share is the same as basic net loss per share for the nine months ended September 29, 2006 because potential common shares, such as common shares issuable upon the exercise of stock options, are only considered when their effect would be dilutive. During the three and nine months ended September 29, 2006, 8.9 million and 11.0 million, respectively, of potentially dilutive shares, consisting of options, were excluded from the net income (loss) per share computations, because their effect was antidilutive. During the three and nine months ended September 30, 2005, 9.7 million and 10.3 million, respectively, of potentially dilutive shares, consisting of options, were excluded from the net income (loss) per share computations, because their effect was antidilutive.

Following is a reconciliation of the numerators and denominators of the basic and diluted net loss per share computations (in thousands, except per share data):

	Three Months Ended		Nine Months Ended	
	September 29, 2006	September 30, 2005	September 29, 2006	September 30, 2005
Net income (loss) (numerator)	$ 4,016	$ (2,891)	$ (4,034)	$ (3,715)
Shares calculation (denominator):				
Weighted average shares outstanding basic	74,588	73,554	74,286	73,168
Effect of dilutive securities:				
Potential common stock relating to stock options	462			
Average shares outstanding diluted	75,050	73,554	74,286	73,168
Net income (loss) per share basic	$ 0.05	$ (0.04)	$ (0.05)	$ (0.05)
Net income (loss) per share diluted	$ 0.05	$ (0.04)	$ (0.05)	$ (0.05)

Note 12: Comprehensive Income (Loss)

The Company s total comprehensive income (loss) was as follows (in thousands):

	Three Months Ended		Nine Months Ended	
	September 29, 2006	September 30, 2005	September 29, 2006	September 30, 2005
Net income (loss)	$ 4,016	$ (2,891)	$ (4,034)	$ (3,715)
Change in unrealized gain (loss) on investments, net	83	(35)	173	(46)
Foreign currency translation	19	(286)	125	(164)
Total comprehensive income (loss)	$ 4,118	$ (3,212)	$ (3,736)	$ (3,925)

Note 13: Segment Information

Operating segments are defined as components of an enterprise that engage in business activities for which separate financial information is available and evaluated by the chief operating decision maker. Previously, the Company was

organized into two operating segments: BAN, for fiber optic systems, and CS, for digital headend systems. Each segment had its own management team directing its product development, marketing strategies and its customer service requirements. A separate sales force generally supported both segments with appropriate product and market specialization as required.
The Company restructured its CS and BAN segments into one consolidated group in the fourth quarter of 2005 and effective as of January 1, 2006 no longer has two operating segments. The restructuring involved merging the manufacturing operations, research and development, and marketing departments into one segment.

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Geographic Information (in thousands):

	Three Months Ended		Nine Months Ended	
	September 29, 2006	September 30, 2005	September 29, 2006	September 30, 2005
Net sales:				
United States	$ 29,265	$ 33,954	$ 81,968	$ 115,526
Canada	7,408	2,591	12,216	6,515
International	26,183	24,415	78,162	71,597
Total	$ 62,856	$ 60,960	$ 172,346	$ 193,638

In the third quarter of 2006, sales to Cox Communications and Comcast accounted for 13% and 10% of net sales, respectively, and in the third quarter of 2005, sales to a reseller for a major telco accounted for 13% of net sales. In the first nine months of 2006, no customer had sales that accounted for more than 10% of net sales, and in the first nine months of 2005, sales to Comcast accounted for 21% of net sales.

Note 14: Related Party

A director of Harmonic is also a director of Terayon Communications, from which the Company purchases products for resale. Product purchases from Terayon were approximately $1.3 million and $2.8 million, for the three and nine months ended September 29, 2006, respectively. Product purchases from Terayon were approximately $1.9 million and $18.9 million, for the three and nine months ended September 30, 2005, respectively. As of September 29, 2006 and December 31, 2005, Harmonic had liabilities to Terayon of approximately $0.9 million and $0.7 million, respectively, for inventory purchases.

Note 15: Guarantees

Warranties. The Company accrues for estimated warranty costs at the time of product shipment. Management periodically reviews the estimated fair value of its warranty liability and adjusts based on the terms of warranties provided to customers, historical and anticipated warranty claims experience, and estimates of the timing and cost of specified warranty claims. Activity for the Company s warranty accrual, which is included in accrued liabilities is summarized below (in thousands):

	Three Months Ended		Nine Months Ended	
	September 29, 2006	September 30, 2005	September 29, 2006	September 30, 2005
Balance at beginning of the period	$ 6,018	$ 5,425	$ 6,166	$ 5,429
Accrual for warranties	1,383	1,517	3,404	4,042
Warranty costs incurred	(985)	(1,128)	(3,154)	(3,678)
BTL acquisition				21
Balance at end of the period	$ 6,416	$ 5,814	$ 6,416	$ 5,814

Standby Letters of Credit. As of September 29, 2006 the Company s financial guarantees consisted of standby letters of credit outstanding, which were principally related to customs bond requirements, performance bonds and state requirements imposed on employers. The maximum amount of potential future payments under these arrangements was $0.8 million.

Indemnification Obligations. Harmonic is obligated to indemnify its officers and the members of its Board of Directors pursuant to its bylaws and contractual indemnity agreements. Harmonic also indemnifies some of its suppliers and customers for specified intellectual property matters pursuant to certain contractual arrangements, subject to certain limitations. The scope of these indemnities varies, but in some instances, includes indemnification for damages and expenses (including reasonable attorneys fees). There have been no claims against us for indemnification pursuant to any of these arrangements and, accordingly, no amounts have been accrued in respect of the indemnifications provisions through September 29, 2006.

Guarantees. As of September 29, 2006, Harmonic had no other guarantees outstanding.

Note 16: Legal Proceedings

Between June 28 and August 25, 2000, several actions alleging violations of the federal securities laws by Harmonic and certain of its officers and directors (some of whom are no longer with Harmonic) were filed in or removed to the United States District Court (the District Court) for the Northern District of California. The actions subsequently were consolidated.

A consolidated complaint, filed on December 7, 2000, was brought on behalf of a purported class of persons who purchased Harmonic s publicly traded securities between January 19 and June 26, 2000. The complaint also alleged claims on behalf of a purported subclass of persons who purchased C-Cube securities between January 19 and May 3, 2000. In addition to Harmonic and certain of its officers and directors, the complaint also named C-Cube Microsystems Inc. and several of its officers and directors as defendants. The complaint alleged that, by making false or misleading statements regarding Harmonic s prospects and customers and its acquisition of C-Cube, certain defendants violated sections 10(b) and 20(a) of the Securities Exchange Act of 1934 (the Exchange Act). The complaint also alleged that certain defendants violated section 14(a) of the Exchange Act and sections 11, 12(a)(2), and 15 of the Securities Act of 1933 (the Securities Act) by filing a false or misleading registration statement, prospectus, and joint proxy in connection with the C-Cube acquisition.

On July 3, 2001, the District Court dismissed the consolidated complaint with leave to amend. An amended complaint alleging the same claims against the same defendants was filed on August 13, 2001. Defendants moved to dismiss the amended complaint on September 24, 2001. On November 13, 2002, the District Court issued an opinion granting the motions to dismiss the amended complaint without leave to amend. Judgment for defendants was entered on December 2, 2002. On December 12, 2002, plaintiffs filed a motion to amend the judgment and for leave to file an amended complaint pursuant to Rules 59(e) and 15(a) of the Federal Rules of Civil Procedure. On June 6, 2003, the District Court denied plaintiffs motion to amend the judgment and for leave to file an amended complaint. Plaintiffs filed a notice of appeal on July 1, 2003. The appeal was heard by a panel of three judges of the United States Court of Appeals for the Ninth Circuit (the Ninth Circuit) on February 17, 2005.

On November 8, 2005, the Ninth Circuit panel affirmed in part, reversed in part, and remanded for further proceedings the decision of the District Court. The Ninth Circuit affirmed the District Court s dismissal of the plaintiffs fraud claims under Sections 10(b), 14(a), and 20(a) of the Exchange Act with prejudice, finding that the plaintiffs failed to adequately plead their allegations of fraud. The Ninth Circuit reversed the District Court s dismissal of the plaintiffs claims under Sections 11 and 12(a)(2) of the Securities Act, however, finding that those claims did not allege fraud and therefore were subject to only minimal pleading standards. Regarding the secondary liability claim under Section 15 of the Securities Act, the Ninth Circuit reversed the dismissal of that claim against Anthony J. Ley, Harmonic s Chairman and Chief Executive Officer, and affirmed the dismissal of that claim against Harmonic, while granting leave to amend. The Ninth Circuit remanded the surviving claims to the District Court for further proceedings.

On November 22, 2005, both the Harmonic defendants and the plaintiffs petitioned the Ninth Circuit for a rehearing of the appeal. On February 16, 2006 the Ninth Circuit denied both petitions. On May 17, 2006 the plaintiffs filed an amended complaint on the issues remanded for further proceedings by the Ninth Circuit, to which the Harmonic defendants responded on with a Motion to Dismiss. Briefing on the motion was completed in August 2006. There will be no hearing unless the Court requests one.

A derivative action purporting to be on behalf of Harmonic was filed against its then-current directors in the Superior Court for the County of Santa Clara on September 5, 2000. Harmonic also was named as a nominal defendant. The complaint is based on allegations similar to those found in the securities class action and claims that the defendants breached their fiduciary duties by, among other things, causing Harmonic to violate federal securities laws. The derivative action was removed to the United States District Court for the Northern District of California on September 20, 2000. All deadlines in this action were stayed pending resolution of the motions to dismiss the securities class action. On July 29, 2003, the Court approved the parties stipulation to dismiss this derivative action without prejudice and to toll the applicable limitations period pending the Ninth Circuit s decision in the securities action. Pursuant to the stipulation, defendants have provided plaintiff with a copy of the mandate issued by the Ninth Circuit in the securities action.

A second derivative action purporting to be on behalf of Harmonic was filed in the Superior Court for the County of Santa Clara on May 15, 2003. It alleged facts similar to those previously alleged in the securities class action and the federal derivative action. The complaint named as defendants former and current Harmonic officers and directors, along with former officers and directors of C-Cube Microsystems, Inc., who were named in the securities class action. The complaint also named Harmonic as a nominal defendant. The complaint alleged claims for abuse of control, gross mismanagement, and waste of corporate assets against the Harmonic defendants, and claims for breach of fiduciary duty, unjust enrichment, and negligent misrepresentation against all defendants. On July 22, 2003, the Court approved the parties stipulation to stay the case pending resolution of the appeal in the securities class action. Following the decision of the Ninth Circuit discussed above, on May 9, 2006, defendants filed demurrers to this complaint. The plaintiffs then filed an amended complaint on July 10, 2006, which names only the Harmonic defendants. The defendants filed demurrers to the amended complaint, and a case management conference and hearing are scheduled for December 19, 2006.

Based on its review of the surviving claims in the securities class actions, Harmonic believes that it has meritorious defenses and intends to defend itself vigorously. There can be no assurance, however, that Harmonic will prevail. No estimate can be made of the possible range of loss associated with the resolution of this contingency, and accordingly, Harmonic has not recorded a liability. An unfavorable outcome of this litigation could have a material adverse effect on Harmonic s business, operating results, financial position or cash flows.

On July 3, 2003, Stanford University and Litton Systems filed a complaint in U.S. District Court for the Central District of California alleging that optical fiber amplifiers incorporated into certain of Harmonic s products infringe U.S. Patent No. 4859016. This patent expired in September 2003. The complaint seeks injunctive relief, royalties and damages. Harmonic has not been served in the case. At this time, we are unable to determine whether we will be able to settle this litigation on reasonable terms or at all, nor can we predict the impact of an adverse outcome of this litigation if we elect to defend against it. No estimate can be made of the possible range of loss associated with the resolution of this contingency and accordingly, we have not recorded a liability associated with the outcome of a negotiated settlement or an unfavorable verdict in litigation. An unfavorable outcome of this matter could have a material adverse effect on Harmonic s business, operating results, financial position or cash flows.

Harmonic is involved in other litigation and may be subject to claims arising in the normal course of business. In the opinion of management the amount of ultimate liability with respect to these matters in the aggregate will not have a material adverse effect on the Company or its operating results, financial position or cash flows.

Note 17: Entone Acquisition

In the third quarter of 2006, Harmonic entered into a definitive agreement to acquire the video networking software business of Entone Technologies, Inc., a privately-held company based in San Mateo, Ca, with research and development facilities in Hong Kong. The Entone software solutions encompassing content ingest, distributed content management and video streaming facilitate the provisioning of personalized video services including video-on-demand (VOD), network personal video recording (nPVR), time-shifted television and targeted advertisement insertion. By combining Harmonic s industry-leading video headend, edge and access network solutions with Entone s on-demand software, Harmonic expects to be able to provide cable, satellite and telco/IPTV service providers an advanced and uniquely integrated delivery system for the next generation of both broadcast and personalized IP-delivered video services.

The agreed upon purchase price is comprised of $26 million in cash and the value of 3.54 million shares of Harmonic common stock (with an approximate market value of $19.0 million at August 21, 2006), as determined in accordance with the terms of the definitive agreement. In addition, Harmonic will assume certain liabilities of $1.5 million and invest $2.5 million in the form of a convertible note in Entone s consumer premise equipment (CPE) business, which will be spun out to Entone s existing stockholders immediately prior to the closing of the acquisition. The Company currently expects the acquisition of Entone will be completed in the fourth quarter of 2006.

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

This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, including statements regarding our expectations of continued customer concentration; our expectations regarding future sales for a major telecommunications operator; our expectations that sales to cable television, satellite and telecommunications operators will constitute a significant portion of net sales for the foreseeable future; our expectation that international sales will continue to account for a significant portion of our net sales for the foreseeable future; our expectation that, following the acquisition of Entone, we will be able to provide cable, satellite and telco/IPTV service providers with an advanced and uniquely integrated delivery system for the next generation of broadcast and personalized IP-delivered video services; our expectations regarding our capital expenditures during the remainder of 2006; our expectation that we will not receive any tax benefits in fiscal 2006 for any expense deductions resulting from expensing of stock options or shares issued under our ESPP; our expectations regarding the amount of amortization expense we will incur during the remainder of 2006; our expectation that near-term changes in foreign exchange rates will not have a material impact on our operating results, financial position and liquidity; our belief that any ultimate liability of Harmonic with respect to certain litigation arising in the normal course of business will not, in the aggregate, have a material adverse effect on us or our operating results, financial position or cash flows; our belief that our existing liquidity sources will satisfy our cash requirement for at least the next 12 months; and our expectation that operating results are likely to fluctuate in the future. These statements involve risks and uncertainties as well as assumptions that, if they were to never materialize or prove incorrect, could cause actual results to differ materially from those projected, expressed or implied in the forward-looking statements. These risks and uncertainties include those set forth under Risk Factors below and elsewhere in this Quarterly Report on Form 10-Q and that are otherwise described from time to time in Harmonic s filings with the Securities and Exchange Commission.

Overview

Harmonic designs, manufactures and sells products for video processing and edge and access applications. In addition, we provide network management software and have recently introduced new application software products. Harmonic also provides technical support services to its customers worldwide. Our video processing products provide broadband operators with the ability to accept a variety of signals from different sources, in different protocols, and to organize, manage and distribute this content to maximize use of the available bandwidth. Our edge products enable operators to deliver customized broadcast or narrowcast on-demand services to their subscribers, and our access products, which consist mainly of optical transmission products, node platforms and return path products, allow operators to deliver video, data and voice services over their physical networks.

These products and services enable network operators to provide a range of interactive and advanced digital services that include digital video, video-on-demand (VOD), high-definition television (HDTV), high-speed Internet access and telephony. They enable our customers to process video for distribution over cable, satellite, telephone and wireless networks. We also provide fiber optic transmission systems to cable television operators and to certain telephone companies that offer video services to their customers.

The sequential increases in net sales in 2005 and 2004 that Harmonic experienced reflected an improved industry capital spending environment worldwide which favorably impacted us. We believe that this improvement in the industry capital spending environment was, in part, a result of the intensifying competition between cable and satellite operators to offer more channels of digital video and new services, such as VOD and HDTV, and in part the result of the entry of telephone companies into the business of delivering video services to their subscribers. We also believe that the improvement was due to more favorable conditions in industry capital markets and the completion or resolution of certain major business combinations, financial restructurings and regulatory issues.

In the third quarter of 2006, Harmonic s net sales increased 3% compared to the third quarter of 2005, although net sales in the first nine months of 2006 decreased by 11% compared to the first nine months of 2005. We believe that the increase in sales in the third quarter of 2006 compared to the same period in 2005 was due to increased shipments of a broad range of new video delivery solutions to domestic cable customers and new international telco and satellite customers. The decrease in net sales in the first nine months of 2006 compared to the first nine months of 2005 was attributable to weaker spending by domestic cable customers in the first half of 2006, the significant

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amount of third party products sold to our end customers in the first nine months of 2005, as well as supply chain constraints and delays in the completion of projects for our international telco customers during the first nine months of 2006. Our quarterly and annual results may fluctuate significantly due to spending by our customers, our revenue recognition policies and the timing of the receipt of orders, as well as other factors, including those set forth in the section entitled Risk Factors in this Quarterly Report on Form 10-Q.

Harmonic often recognizes a significant portion, or the majority, of its revenues in the last month of the quarter. Harmonic establishes its expenditure levels for product development and other operating expenses based on projected sales levels, and expenses are relatively fixed in the short term. Accordingly, variations in timing of sales can cause significant fluctuations in operating results. In addition, because a significant portion of Harmonic s business is derived from orders placed by a limited number of large customers, the timing of such orders can also cause significant fluctuations in our operating results. Harmonic s expenses for any given quarter are typically based on expected sales and if sales are below expectations, our operating results may be adversely impacted by our inability to adjust spending to compensate for the shortfall.

Historically, a majority of our net sales have been to relatively few customers, and due in part to the consolidation of ownership of cable television and direct broadcast satellite systems, we expect this customer concentration to continue for the foreseeable future. In the third quarter of 2006, sales to Cox Communications and Comcast accounted for 13% and 10% of net sales, respectively, and in the third quarter of 2005, sales to a reseller for a major telco accounted for 13% of net sales. In the first nine months of 2006, no customer had sales that accounted for more than 10% of net sales, and in the first nine months of 2005, sales to Comcast accounted for 21% of net sales.

Sales to customers outside of the U.S. in the third quarter and first nine months of 2006 represented 53% and 52% of net sales, respectively, compared to 44% and 40% for the comparable periods in 2005. A significant portion of international sales are made to distributors and system integrators, which are generally responsible for importing the products and providing installation and technical support and service to customers within their territory. Sales denominated in foreign currencies were approximately 9% of net sales in the first nine months of 2006 compared to 7% for the comparable period of 2005. We expect international sales to continue to account for a significant portion of our net sales for the foreseeable future.

In the third quarter of 2006, the Company completed its facilities rationalization plan resulting in more efficient use of our Sunnyvale campus and vacated several buildings, some of which were subsequently subleased. The Company also revisited its estimates of excess facilities reserves for buildings previously vacated due to entering into sublease agreements during the quarter. This resulted in a net charge for excess facilities of $2.1 million in the third quarter of 2006.

In May 2006,pt; FONT-WEIGHT: bold">

				Aggregate Intrinsic Value
Outstanding at December 31, 2011 (4,202,786 options exercisable at a weighted-average exercise price of $15.05 per share)	4,863,239	$15.31	3.44	$8,817,049
Options granted (weighted-average fair value of $6.69 per share)	7,000	15.96		
Options exercised	(661,843)	11.09		
Options forfeited and expired	(59,041)	20.69		
Outstanding at June 30, 2012	4,149,355	15.91	3.08	18,556,231
Options exercisable at June 30, 2012 and expected to become exercisable	4,127,134	15.91	3.06	18,465,230
Options vested and exercisable at June 30, 2012				

3,768,592	$15.83	2.90	$17,125,148

The total fair value of options that vested during the three months ended June 30, 2012 and 2011 was $0.8 million and $1.5 million, respectively, and the total fair value of options that vested during the six months ended June 30, 2012 and 2011 was $1.7 million and $3.1 million. The total intrinsic value of options exercised during the three months ended June 30, 2012 and 2011 was $2.8 million and $0.7 million, respectively. The total intrinsic value of options exercised was $5.5 million during both the six months ended June 30, 2012 and 2011. Net cash proceeds from the exercise of stock options were $3.4 million for the three months ended June 30, 2012 and $0.7 million for the three months ended June 30, 2011. Net cash proceeds from the exercise of stock options were $7.3 million for the six months ended June 30, 2012 and $4.3 million for the six months ended June 30, 2011. At June 30, 2012, unamortized compensation expense related to unvested options was approximately $2.6 million, net of estimated forfeitures. The weighted average period over which compensation expense related to these options will be recognized is approximately 1.8 years.

The employee stock-based compensation expense recognized under Accounting Standards Codification ("ASC") 718-10-30 Compensation – Stock Compensation –Overall - Initial Measurement, was determined using the Black-Scholes option pricing model. Option pricing models require the input of subjective assumptions and these assumptions can vary over time. The Company did not grant any stock option awards during the three months ended June 30, 2012. Weighted-average assumptions to determine the fair values of stock option awards granted were as follows:

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	Three months ended June 30,				Six months ended June 30,			
	2012		2011		2012		2011	
Expected term (years)	3.8		4.0		4.1		4.0	
Expected volatility	53.4	%	53.0	%	53.4	%	52.9	%
Risk-free interest rate	0.6	%	1.3	%	0.6	%	1.4	%
Dividend yield	-		-		-		-	

In estimating the expected term, the Company considers its historical stock option exercise experience, post vesting cancellations and remaining contractual term of the options outstanding. In estimating the expected volatility, the Company uses its own historical data to determine its estimated expected volatility. The Company uses the U.S. Treasury constant maturity yield based on the expected term for its risk-free interest rate and a dividend yield of zero as it does not issue dividends. The Company applies a forfeiture rate that is based on options that have been forfeited historically.

Restricted Stock

The Company grants restricted stock units (RSUs), which vest generally over four years as determined by the Company's Compensation Committee, and are issued upon vesting. Before vesting, these restricted stock units are not eligible for dividends, if and when declared. A summary of the restricted stock units is presented in the table below:

	Restricted Stock Units		Weighted Average Grant Date Fair Value Per Share	Weighted Average Remaining Recognition Period (Years)
Outstanding at December 31, 2011	1,299,556	$	16.87	2.71
Awards granted	830,931		18.22	
Awards released	(235,159)		17.66	
Awards forfeited	(51,664)		16.92	
Outstanding at June 30, 2012	1,843,664	$	17.50	2.57

The total expense recognized for RSUs was $2.9 million for the three months ended June 30, 2012 and $2.1 million for the three months ended June 30, 2011. The total expense recognized for RSUs was $5.1 million for the six months ended June 30, 2012 and $4.6 million for the six months ended June 30, 2011, respectively. The intrinsic value on the vesting date related to restricted stock units released for the three months ended June 30, 2012 and 2011 was $2.4 million and $1.4 million, respectively, and the intrinsic value on the vesting date related to restricted stock units released for the six months ended June 30, 2012 and 2011 was $4.4 million and $3.1 million, respectively. The intrinsic value related to restricted stock units outstanding at June 30, 2012 and 2011 was $36.6 million and $21.8 million, respectively. At June 30, 2012, the unamortized compensation expense related to unvested restricted stock units was approximately $22.1 million, net of estimated forfeitures, with a weighted average remaining recognition period of 2.6 years.

On February 25, 2010, the Board granted 416,000 performance units to the Company’s executive officers. These performance units generally vest over four years, with a graded acceleration feature that allows all or a portion of these awards to be accelerated if certain performance conditions are satisfied. The amount of shares to be accelerated is based on achieving certain performance targets, with the minimal acceleration occurring if performance exceeds at least 110% of non-GAAP earnings per share as set forth in the Company’s annual operating plan approved by the Board, as determined by the Compensation Committee in its sole discretion. The Compensation Committee has the discretion not to accelerate any shares, if it so chooses, even if the performance targets are met. To date, none of the shares have been accelerated.

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The Company granted 153,000 Time-based RSUs to its CEO in February 2011. In the fourth quarter of 2011, the compensation committee proposed modifying half of the Time-based RSUs to Performance-based RSUs and on February 7, 2012 the Board approved the performance goals based on the Company’s 2012 revenue (“2012 Modification”). The Performance-based RSUs will vest on a quarterly basis during the period following the achievement of the goal. The maximum number of RSUs the CEO may receive is 100% of the Performance-based RSUs originally granted.

On February 14, 2012, the Board granted 413,000 Restricted Stock Units (“RSUs) to the Company’s executive officers. Fifty percent of RSUs granted to Company’s executive officers will vest over two years on a quarterly basis (“Time-based RSUs”) and 50% of the units will represent a target number of RSUs awarded upon achievement of a pre-determined goal (“2012 Executive RSUs ”) for the Company’s revenue in 2013 (“Performance-based RSUs”). Half of these Performance-based RSUs will vest when earned with the remainder vesting during the following two years on a quarterly basis. The maximum number of RSU an executive employee may receive is 300% of the Performance-based RSUs originally granted. The Performance-based RSUs earned will be reduced by maximum 15% in the event that the Company’s total shareholder return (“TSR”), defined as the cumulative change in share price plus dividends, as compared to the Company’s compensation peer group is below a specified percentile for calendar years 2012 and 2013.

On April 24, 2012, the Company granted 344,650 RSUs to its existing non-executive employees. These RSUs grants include 219,317 Time-based RSUs and 125,333 Performance-based RSUs. The Performance-based RSUs will be a target number of RSUs awarded upon achievement of a pre-determined goal (“2012 Non-Executive RSUs”) for the reported revenue of the Company, certain regions or product-line divisions in 2013. Half of these Performance-based RSUs will vest when earned with the remainder vesting during the following two years on a quarterly basis. The maximum number of RSUs an employee may receive is 300% of the Performance-based RSUs originally granted.

Based on the Company’s revenue forecast as of June 30, 2012, the Company has determined that it is probable that it will be able to achieve the pre-determined goal for the 2012 Modification, 2012 Executive RSUs and for the majority of 2012 Non-Executive RSUs which will allow the eligible employees to receive 100% of the RSUs originally granted. The Company has recorded stock-based compensation expense for the Performance-based RSUs, expected to meet the pre-determined goal, based on grant date fair value adjusted for forfeiture rate which will be amortized based on graded-vesting method.

2004 Employee Stock Purchase Plan

Under the 2004 Employee Stock Purchase Plan (the Purchase Plan), eligible employees may purchase common stock through payroll deductions. Participants may not purchase more than 2,000 shares in a six-month offering period or stock having a value greater than $25,000 in any calendar year as measured at the beginning of the offering period in accordance with the Internal Revenue Code and applicable Treasury Regulations. A total of 200,000 shares of common stock were reserved for issuance under the Purchase Plan. The Purchase Plan provides for an automatic annual increase beginning on January 1, 2005 by an amount equal to the lesser of: 1,000,000 shares, 2% of the outstanding shares of common stock on the first day of the year, or a number of shares as determined by the Board of Directors. For the six months ended June 30, 2012 and 2011, 97,247 shares and 70,685 shares, respectively, were issued under the Purchase Plan. The following is a summary of the Purchase Plan and changes during the six months ended June 30, 2012:

Available Shares as of December 31, 2011	3,693,210
2012 Additions	676,520
2012 Purchases	(97,247)
Available Shares as of June 30, 2012	4,272,483

The Purchase Plan is considered compensatory under ASC 718-50-25, Compensation – Stock Compensation - Employee Share Purchase Plans - Recognition, and is accounted for in accordance with ASC 718-50-30 Compensation – Stock Compensation - Employee Share Purchase Plans - Initial Measurement - Look-Back Plans. The intrinsic value for stock purchased was $0.7 million and $0.2 million for each of the six months ended June 30, 2012 and 2011, respectively. The unamortized expense as of June 30, 2012 was $0.1 million, which will be recognized over 0.1 years. The Black-Scholes option pricing model was used to value the employee stock purchase rights. For the six months ended June 30, 2012 and 2011, the following weighted average assumptions were used in the valuation of the stock purchase rights:

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	Six months ended June 30,			
	2012		2011	
Expected term (years)	0.5		0.5	
Expected volatility	50.7	%	37.5	%
Risk-free interest rate	0.1	%	0.2	%
Dividend yield	-		-	

Cash proceeds from employee stock purchases for each of the six months ended June 30, 2012 and 2011 was $1.0 million and $0.9 million, respectively.

3. Inventories - Inventories consist of the following (in thousands):

		June 30, 2012		December 31, 2011
Work in progress	$	18,880	$	11,596
Finished goods		10,575		8,508
Total inventories	$	29,455	$	20,104

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

		June 30, 2012		December 31, 2011
Deferred revenue and customer prepayments	$	2,820	$	3,603
Stock rotation reserve		1,203		1,086
Legal expenses and settlement costs		607		911
Warranty		443		561
Other		1,775		1,684
Total accrued liabilities	$	6,848	$	7,845

A roll-forward of the warranty reserve for the six months ended June 30, 2012 and 2011 is as follows (in thousands):

		Six months ended June 30,				
		2012			2011	
Balance at beginning of year	$	561		$	764	
Warranty costs		(124	)		(333	)
Unused warranty provision		(213	)		(220	)
Warranty provision for product sales		219			515	
Balance at end of period	$	443		$	726	

5. Net Income per Share — Basic net income per share excludes dilution and is computed by dividing net income by the weighted average number of common shares outstanding for the period. Diluted net income per share is calculated using the treasury stock method and reflects the potential dilution that would occur if outstanding securities or other contracts to issue common stock were exercised or converted into common stock. For the three and six months ended

June 30, 2012 and 2011, the Company had securities outstanding, which could potentially dilute basic net income per share in the future, but were excluded from the computation of diluted net income per share in the periods presented, as their effect would have been anti-dilutive. The following table sets forth the computation of basic and diluted net income per share (in thousands, except per share amounts):

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	Three months ended June 30,		Six months ended June 30,	
	2012	2011	2012	2011
Numerator:				
Net income	$6,592	$3,482	$9,587	$5,375
Denominator:				
Weighted average oustanding shares used to compute basic net income per share	34,665	33,846	34,385	34,432
Effect of dilutive securities	1,332	1,057	1,275	1,166
Weighted average oustanding shares used to compute diluted net income per share	35,997	34,903	35,660	35,598
Net income per share - basic	$0.19	$0.10	$0.28	$0.16
Net income per share - diluted	$0.18	$0.10	$0.27	$0.15

For the three months ended June 30, 2012 and 2011, approximately 1.3 million and 4.1 million weighted common stock equivalents, respectively, were excluded from the calculation of diluted net income per share because their inclusion would have been anti-dilutive. For the six months ended June 30, 2012 and 2011, approximately 1.7 million and 4.3 million weighted common stock equivalents, respectively, were excluded from the calculation of diluted net income per share because their inclusion would have been anti-dilutive.

6. Segment Information

As defined by the requirements of ASC 280-10-50 Segment Reporting – Overall - Disclosure, the Company operates in one reportable segment that includes the design, development, marketing and sale of high-performance, mixed-signal analog semiconductors for the communications, computing, consumer, and industrial markets. Geographic revenue is based on the location to which customer shipments are delivered. For the three and six months ended June 30, 2012 and 2011, the Company derived substantially all of its revenue from sales to customers located outside North America. The following is a list of customers whose sales exceeded 10% of revenue for the three and six months ended June 30, 2012 and 2011.

	Three months ended June 30,				Six months ended June 30,			
Customers	2012		2011		2012		2011	
A	16	%	16	%	15	%	16	%
B	13	%	*		14	%	*	

(*) represents less than 10%

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

	Three months ended June 30,	Six months ended June 30,

Country	2012	2011	2012	2011
China	$ 35,091	$ 31,203	$ 64,184	$ 54,880
Taiwan	7,820	5,156	14,235	10,285
Korea	2,600	4,417	4,559	8,844
Europe	3,793	3,567	7,983	7,042
Japan	2,355	2,740	4,661	5,718
USA	1,601	860	2,713	1,966
Other	5,347	3,685	10,756	7,361
Total	$ 58,607	$ 51,628	$ 109,091	$ 96,096

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

Product Family	Three months ended June 30, 2012	Three months ended June 30, 2011	Six months ended June 30, 2012	Six months ended June 30, 2011
DC to DC Converters	$ 51,165	$ 44,771	$ 95,507	$ 83,351
Lighting Control Products	7,442	6,857	13,584	12,745
Total	$ 58,607	$ 51,628	$ 109,091	$ 96,096

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

	June 30, 2012	December 31, 2011
China	$ 38,170	$ 32,566
United States	21,835	15,662
Taiwan	73	98
Japan	68	70
Other	44	51
TOTAL	$ 60,190	$ 48,447

On July 8, 2011, the Company purchased the property located at 79 Great Oaks Boulevard in San Jose, California, to be used as its new headquarters and sales offices. The property consists of an approximately 106,262 square foot office building and approximately 5.5 acres of land. The $11.0 million purchase price for the property was allocated based on an independent third party valuation with $5.0 million attributable to the building and $6.0 million attributable to the land. The Company moved to its new headquarters and started to depreciate the building in May 2012. The increase of $6.2 million in the long-lived assets for the six months ended June 30, 2012 for the United States was primarily related to the building improvements at this new location. Buildings and building improvements have a depreciation life of up to 40 years.

7. Litigation

On September 16, 2011 and September 29, 2011, two nearly identical shareholder derivative actions were filed in the United States District Court for the Northern District of California and the California Superior Court for Santa Clara County, naming as defendants certain of the Company’s current and former directors and officers and the Company’s compensation advisory firm. The complaints asserted claims for, among other things, breach of fiduciary duty in connection with the directors' approval of compensation for the Company's executive officers during 2010. The complaints each sought an award of damages in favor of the Company, equitable relief, costs and attorney's fees. On March 2, 2012, the parties in the state court action stipulated to the dismissal without prejudice of that action. On April 3, 2012, a hearing was held in the United States District Court on the defendants’ motions to dismiss the case. On June 13, 2012, the United States District Court issued an order granting the motions and dismissing the complaint without prejudice. The court ruled that the plaintiff had failed to sufficiently allege that pre-suit demand on the Company’s board of directors was excused, and granted the plaintiff leave to amend the complaint. The plaintiff subsequently informed the defendants that it did not intend to amend the complaint. On July 9, 2012, the parties in the federal court action stipulated to the dismissal without prejudice of that action, and on July 10, 2012, the federal court signed an order dismissing the action without prejudice.

On May 3, 2012, the United States District Court for the Northern District of California issued an order finding O2 Micro International, Ltd. (“O2 Micro”) liable for approximately $9.1 million in attorneys’ fees and non-taxable costs, plus interest, in connection with the patent litigation that the Company won in 2010. This award is in addition to the approximately $340,000 in taxable costs that the Court had earlier ordered O2 Micro to pay to the Company in connection with the same lawsuit. The matter originated when O2 Micro filed complaints against the Company in both the United States International Trade Commission (“ITC”) and the Northern District of California, alleging that the Company infringed four O2 Micro patents but then voluntarily dismissed three patents. In June 2010, the ITC found that the Company's products did not infringe O2 Micro’s patent. Subsequently, O2 Micro unilaterally dismissed its infringement claims with prejudice, and granted the Company and its customers broad covenants not to sue in the district court case. On March 3, 2011, the Court ordered O2 Micro to pay the Company $339,315.13 in costs. The Court also found that “O2 Micro engaged in a vexatious litigation strategy and litigation misconduct,” entitling the Company to its reasonable attorneys' fees. O2 Micro's vexatious litigation strategy consisted of filing lawsuits against the Company and its customers; only to dismiss them after substantial litigation had taken place. This allowed O2 Micro to damage the Company's business while avoiding trials at which the validity of its patents would be challenged. Since that time, the Company submitted the documentation for its attorneys’ fees and non-taxable costs. O2 Micro challenged those fees on various grounds. On May 3, 2012, the Court accepted the Company’s figures and entered an order awarding $8,419,429 in attorneys’ fees, and $663,151 in non-taxable costs, plus interest. The Court then entered judgment for the Company. The Company anticipates that O2 Micro will appeal the Court’s orders and the final judgment. These amounts will be recognized in the Consolidated Financial Statements of the Company when all related appeals have been exhausted and collectability is probable.

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The Company and certain of its subsidiaries are parties to actions and proceedings incident to the Company's business in the ordinary course of business, including litigation regarding its intellectual property, challenges to the enforceability or validity of its intellectual property and claims that the Company’s products infringe on the intellectual property rights of others. These proceedings often involve complex questions of fact and law and may require the expenditure of significant funds and the diversion of other resources to prosecute and defend. The Company defends itself vigorously against any such claims.

In December 2011, the Company entered into a settlement and license agreement with a third-party company for infringement of the Company’s patent whereby the Company will receive a total of $2 million which will be paid in equal installments of $0.3 million in each quarter of 2012 and the remainder will be paid in two equal installments in first two quarters of 2013. For the three and six months ended June 30, 2012, the Company received the $0.3 million and $0.6 million payments, respectively, which were recorded as credits to litigation expenses in the Condensed Consolidated Statements of Operations.

8. Fair Value Measurements

The following is a schedule of Company’s cash and cash equivalents, short-term investments and long-term investments as of June 30, 2012 and December 31, 2011 (in thousands):

	Estimated Fair Market Value as of	
	June 30, 2012	December 31, 2011
	(In thousands)	
Cash, Cash Equivalents and Investments		
Cash in Banks	51,530	43,305
Money Market Funds	30,114	51,066
Government Agencies/ Treasuries	103,013	79,827
Auction-Rate Securities backed by Student-Loan Notes	11,714	13,675
Total Cash, Cash Equivalents and Investments	196,371	187,873
Reported as:		
Cash and Cash Equivalents	81,644	96,371
Short-term Investments	103,013	77,827
Long-term Investments	11,714	13,675
Total Cash, Cash Equivalents and Investments	196,371	187,873

The contractual maturities of the Company’s investments classified as available-for-sale as of June 30, 2012 and December 31, 2011 is as follows (in thousands):

	June 30, 2012	December 31, 2011
Less than 1 year	25,992	45,133
1 - 5 years	77,021	32,694
Greater than 5 years	11,714	13,675

	114,727	91,502

The following table details the fair value measurements as of June 30, 2012 and December 31, 2011 within the fair value hierarchy of the financial assets that are required to be recorded at fair value (in thousands):

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	Fair Value Measurements at June 30, 2012 Using			
	Total	Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3
Money Market Funds	$ 30,114	$ 30,114	$ -	$ -
US Treasuries and US Government Agency Bonds	103,013	-	103,013	-
Long-term available-for-sale auction-rate securities	11,714	-	-	11,714
	$ 144,841	$ 30,114	$ 103,013	$ 11,714

	Fair Value Measurements at December 31, 2011 Using			
	Total	Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3
Money Market Funds	$ 51,066	$ 51,066	$ -	$ -
US Treasuries and US Government Agency Bonds	79,827	-	79,827	-
Long-term available-for-sale auction-rate securities	13,675	-	-	13,675
	$ 144,568	$ 51,066	$ 79,827	$ 13,675

At June 30, 2012, fixed income available-for-sale securities included $103.0 million in US government agencies and treasuries, all of which were classified as short-term investments. The Company also had $30.1 million invested in money market funds. From these investments, there were $22,000 in unrealized losses. The impact of gross unrealized gains and losses was not material. At June 30, 2012, the Company also had $12.3 million in face value of auction-rate securities, all of which are classified as long-term available-for-sale investments.

At December 31, 2011, fixed income available-for-sale securities include securities issued by government agencies and treasuries, $77.8 million of which are classified as short-term investments and $2.0 million which are classified as cash equivalents. The Company also had $51.1 million invested in money market funds. At December 31, 2011, there were $17,000 in unrealized losses from these investments. The impact of gross unrealized gains and losses was not material. At December 31, 2011, the Company also had $14.4 million in face value of auction-rate securities, all of which are classified as long-term available-for-sale investments.

Temporary impairment charges are recorded in accumulated other comprehensive income (loss) within stockholders' equity and has no impact on net income. Other-than-temporary impairment exists when the entity either has the intent to sell the security, it will more likely than not be required to sell the security before anticipated recovery or it does not expect to recover the entire amortized cost basis of the security. Other-than-temporary impairment charges are recorded in other income (expense) in the Condensed Consolidated Statement of Operations.

The following tables summarize unrealized gains and losses related to our investments in marketable securities designated as available-for sale (in thousands):

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	As of June 30, 2012			
	Adjusted Cost	Unrealized Gains or Losses	Total Fair Value	Fair Value of Investments in Unrealized Loss Position
Money Market Funds	$ 30,114	-	$ 30,114	-
US Treasuries and US Government Agency Bonds	103,017	(4)	103,013	51,858
Auction-rate securities backed by Student-Loan Notes	12,245	(531)	11,714	11,714
	145,376	(535)	144,841	63,572

	As of December 31, 2011			
	Adjusted Cost	Unrealized Gains or Losses	Total Fair Value	Fair Value of Investments in Unrealized Loss Position
Money Market Funds	$ 51,066	$ -	$ 51,066	$ -
US Treasuries and US Government Agency Bonds	79,830	(3)	79,827	25,281
Auction-rate securities backed by Student-Loan Notes	14,305	(630)	13,675	13,675
	$ 145,201	$ (633)	$ 144,568	$ 38,956

The Company's level 2 assets consist of U.S. treasuries, U.S. government agency bonds, corporate notes and commercial paper. These securities generally have market prices available from multiple sources, which are used as inputs into a distribution-curve based algorithm to determine fair value.

The Company’s level 3 assets consist of government-backed student loan auction-rate securities, with interest rates that reset through a Dutch auction every 7 to 35 days and which became illiquid in 2008. The following table provides a reconciliation of the beginning and ending balances for the assets measured at fair value using significant unobservable inputs (Level 3) (in thousands):

	Auction-Rate Securities
Ending balances at December 31, 2011	$ 13,675
Sales and Settlement at Par	(100)
Total realized and unrealized gains (losses):	
Included in other income (expense)	-
Included in other comprehensive income	90

Ending balances at March 31, 2012	$	13,665
Sales and Settlement at Par		(2,000)
Total realized and unrealized gains (losses):		
Included in other income (expense)		40
Included in other comprehensive income		9
Ending balances at June 30, 2012	$	11,714

At June 30, 2012, the Company’s investment portfolio included $11.7 million in government-backed student loan auction-rate securities, net of impairment charges of $0.56 million; of which, $0.53 million was temporary and $0.03 million was recorded other-than-temporary. This compares to an investment balance of auction-rate securities as of December 31, 2011 of $13.7 million net of impairment charges of $0.7 million; of which, $0.6 million was temporary and $0.1 million was recorded as other-than-temporary.

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The underlying maturity of these auction-rate securities is up to 35 years. As of June 30, 2012 and December 31, 2011 the portion of the impairment classified as temporary was based on the following analysis:

The decline in the fair value of these securities is not largely attributable to adverse conditions specifically related to these securities or to specific conditions in an industry or in a geographic area;
Management possesses both the intent and ability to hold these securities for a period of time sufficient to allow for any anticipated recovery in fair value;
Management believes that it is more likely than not that the Company will not have to sell these securities before recovery of its cost basis;
Except for the credit loss of $70,000 recognized during the year ended December 31, 2009 for the Company's holdings in auction-rate securities described below, the Company does not believe that there is any additional credit loss associated with other auction-rate securities because the Company expects to recover the entire amortized cost basis;
The face value of $6.0 million of the auction-rate securities remain AAA rated and a face value of $6.3 million of the auction-rate securities having been downgraded by Moody's to A3-Baa3, during the year ended December 31, 2009 and there have been no downgrades since;
All scheduled interest payments have been made pursuant to the reset terms and conditions; and
All redemptions of auction-rate securities representing 68% of the original portfolio purchased by the Company in February 2008 have been at par.

Based on the guidance of ASC 320-10-35 and ASC 320-10-50, the Company evaluated the potential credit loss of each of the auction-rate securities that are currently held by the Company. Based on such analysis, the Company determined that those securities that are not 100% Federal Family Education Loan Program (FFELPS) guaranteed are potentially subject to credit risks based on the extent to which the underlying debt is collateralized and the security-specific student-loan default rates. The Company's portfolio includes two such securities. The senior parity ratio for the two securities is approximately 106%. If, therefore, the student-loan default rate and borrowing rate increases for these issuers, the remaining balance in these trusts may not be sufficient to cover the senior debt. The Company therefore concluded that there is potential credit risk for these two securities and as such, used the discounted cash flow model to determine the amount of credit loss to be recorded. In valuing the potential credit loss, the following parameters were used: 2.0 year expected term, cash flows based on the 90-day t-bill rates for 2.0 year forwards and a risk premium of 5.9%, the amount of interest that the Company was receiving on these securities when the market was last active. During the year ended December 31, 2009, the potential credit loss associated with these securities was $70,000, which the Company deemed other-than-temporary and recorded in other expense in its Consolidated Statement of Operations during 2009. There have been no such losses since. During the three months ended June 30, 2012, the Company was able to redeem one of these two securities at par and therefore, recognized a gain of $40,000 in other expense in its Consolidated Statement of Operations.

Unless a rights offering or other similar offer is made to redeem at par and accepted by the Company, the Company intends to hold the balance of these investments through successful auctions at par, which the Company believes could take approximately 2.0 years.

Determining the fair value of the auction-rate securities requires significant management judgment regarding projected future cash flows which will depend on many factors, including the quality of the underlying collateral, estimated time for liquidity including potential to be called or restructured, underlying final maturity, insurance guaranty and market conditions, among others. To determine the fair value of the auction-rate securities at December 31, 2011 and June 30, 2012, the Company used a discounted cash flow model, for which there are four unobservable inputs: estimated time-to-liquidity, discount rate, credit quality of the issuer and expected interest receipts. A significant increase in the time-to-liquidity or the discount rate inputs or a significant decrease in the credit quality of the issuer or the expected interest receipts inputs in isolation would result in a significantly lower fair value measurement.

The following are the values used in the discounted cash flow model:

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(Continued) (Unaudited)

	June 30, 2012	December 31, 2011
Time-to-Liquidity	24 months	24 months
Expected Return (Based on the requisite treasury rate, plus a contractual penalty rate)	1.8%	1.8%
Discount Rate (Based on the requisite LIBOR, the cost of debt and a liquidity risk premium) and (depending on the credit-rating of the security)	2.6% - 7.4%	3.1% - 7.9%

If the auctions continue to fail, the liquidity of the Company's investment portfolio may be negatively impacted and the value of its investment portfolio could decline.

9. Income Taxes

The income tax provision for the three and six months ended June 30, 2012 was $0.5 million or 7.7% of the Company's income before income taxes and $0.9 million or 8.2% of the pre-tax income, respectively. This differs from the federal statutory rate of 34% primarily because the Company's foreign income was taxed at lower rates and because of the benefit that the Company realized as a result of stock option exercises and restricted units vested. The income tax provision for the three and six months ended June 30, 2011 was $0.6 million or 14.3% of the Company's income before income taxes and $0.8 million or 12.8% of the pre-tax income, respectively. This differs from the federal statutory rate of 34% primarily because the Company's foreign income was taxed at lower rates and because of the benefit that the Company realized as a result of restricted units released.

The Company is subject to examination of its income tax returns by the Internal Revenue Service ("IRS") and other tax authorities. The Company's U.S. Federal income tax returns for the years ended December 31, 2000 through December 31, 2007 are under examination by the IRS. In April 2011, the Company received from the IRS a Notice of Proposed Adjustment, or "NOPA", relating to a cost-sharing agreement entered into by the Company and its international subsidiaries in 2004. In the NOPA, the IRS objected to the Company's allocation of certain litigation expenses between the Company and our international subsidiaries and the amount of "buy-in payments" made by the Company's international subsidiaries to the Company in connection with the cost-sharing agreement, and proposed to increase the Company's U.S. taxable income according to a few alternative methodologies. The methodology resulting in the largest potential adjustment could, if the IRS were to prevail on all matters in dispute, increase the Company's potential federal and state income tax liabilities by up to $37.0 million, plus interest and penalties, if any. In February 2012, the Company received a revised NOPA from the IRS (Revised NOPA). In this revised NOPA, the largest potential adjustment, if the IRS were to prevail on all matters in dispute, has decreased to $10.5 million, plus interest and penalties, if any. The IRS also audited and proposed adjustments on the research and development credits generated in years 2005 through 2007. On March 20, 2012, the Company received an examination report from the IRS, commonly referred to as a "30-day letter", formally proposing adjustments to the taxable years 2005, 2006 and 2007. As of June 30, 2012, a formal protest to the IRS proposed adjustments has been filed. There is no expected timeframe for MPS to receive feedback from the IRS. The Company regularly assesses the likelihood of an adverse outcome resulting from such examinations to determine the adequacy of its provision for income taxes. Based on the technical merits of its tax return filing positions, as of June 30, 2012, the Company believes that it is more-likely-than-not the tax positions it has taken will be sustained upon the resolution of its audits resulting in no material impact on its consolidated financial position and the results of operations and cash flows. As of June 30, 2012, no other audits were in process in any other material jurisdiction.

10. Stock Repurchase Program

On July 27, 2010, the Board of Directors approved a stock repurchase program that authorized MPS to repurchase up to $50.0 million in the aggregate of its common stock between August 2, 2010 and December 31, 2011. In February 2011, the Board of Directors approved an increase from $50.0 million to $70.0 million. From August 2010 through June 2011, the Company repurchased 4,385,289 shares for a total of $70.0 million. During the six months ended June 30, 2011, the following shares have been repurchased through the open market and subsequently retired:

2011 Calendar Year	Shares Repurchased	Average Price Per Share	Value (in thousands)
February	817,500	$15.47	$12,648
March	75,000	$14.17	$1,062
April	917,200	$14.82	$13,617
May	657,800	$16.48	$10,843
June	18,000	$16.79	$302
	2,485,500		$38,472

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

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

- the above-average industry growth of product and market areas that we have targeted,
- our plan to introduce additional new products within our existing product families as well as in new product categories and families
- Our intention to exercise our purchase option with respect to our manufacturing facility in Chengdu, China,
- our belief that we will continue to incur significant legal expenses that vary with the level of activity in each of our legal proceedings,
- the effect of auction-rate securities on our liquidity and capital resources,
- the application of our products in the Communications, Computing, Consumer and Industrial markets continuing to account for a majority of our revenue,
- estimates of our future liquidity requirements,
- the cyclical nature of the semiconductor industry,
- protection of our proprietary technology,
- near term business outlook for 2012,
- the factors that we believe will impact our ability to achieve revenue growth,
- the outcome of the IRS audit of our tax return for the tax years ended December 31, 2000 through 2007,
- the percentage of our total revenue from various market segments, and

the factors that differentiate us from our competitors.

In some cases, words such as “would,” “could,” “may,” “should,” “predict,” “potential,” “targets,” “continue,” “anticipate,” “ex “intend,” “plan,” “believe,” “seek,” “estimate,” “project,” “forecast,” “will,” the negative of these terms or other variations of s terms and similar expressions relating to the future identify forward-looking statements. All forward-looking statements are based on our current outlook, expectations, estimates, projections, beliefs and plans or objectives about our business and our industry. These statements are not guarantees of future performance and are subject to risks and uncertainties. Actual events or results could differ materially and adversely from those expressed in any such forward-looking statements. Risks and uncertainties that could cause actual results to differ materially include those set forth throughout this quarterly report on Form 10-Q and, in particular, in the section entitled “Part II. Other Information, Item 1A. Risk Factors”. Except as required by law, we disclaim any duty to and undertake no obligation to update any forward-looking statements, whether as a result of new information relating to existing conditions, future events or otherwise or to release publicly the results of any future revisions we may make to forward-looking statements to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events. Readers are cautioned not to place undue reliance on such statements, which speak only as of the date of this quarterly report on Form 10-Q. Readers should carefully review future reports and documents that we file from time to time with the Securities and Exchange Commission, such as our annual reports on Form 10-K and any current reports on Form 8-K.

The following management's discussion and analysis should be read in connection with the information presented in our unaudited condensed consolidated financial statements and related notes for the three and six months ended June 30, 2012 included in this report and our audited consolidated financial statements and related notes for the year ended December 31, 2011 included in our Annual Report on Form 10-K filed on March 12, 2012 with the Securities and Exchange Commission.

Overview

We are a fabless semiconductor company that designs, develops, and markets proprietary, advanced analog and mixed-signal semiconductors. We offer products that serve multiple markets, including flat panel televisions, wireless communications, telecommunications equipment, general consumer products, notebook computers, and set top boxes, among others. We believe that we differentiate ourselves by offering solutions that are more highly integrated, smaller in size, more energy efficient, more accurate with respect to performance specifications and, consequently, more cost-effective than many competing solutions. We plan to continue to introduce new products within our existing product families, as well as in new innovative product categories.

We operate in the cyclical semiconductor industry where there is seasonal demand for certain products. We are not and will not be immune from current and future industry downturns, but we have targeted product and market areas that we believe have the ability to offer above average industry performance.

We work with third parties to manufacture and assemble our integrated circuits ("ICs"). This has enabled us to limit our capital expenditures and fixed costs, while focusing our engineering and design resources on our core strengths.

Following the introduction of a product, our sales cycle generally takes a number of quarters to achieve revenue and volume production is usually achieved several months after we receive an initial customer order for a new product. Typical lead time for orders is fewer than 90 days. These factors, combined with the fact that orders in the semiconductor industry can typically be cancelled or rescheduled without significant penalty to the customer, make the forecasting of our orders and revenue difficult.

We derive most of our revenue from sales through distribution arrangements, or direct sales to customers in Asia, where the products we produce are incorporated into end-user products. Out of our total revenue, 91% of our revenue for both the quarters ended June 30, 2012 and 2011 was attributable to direct or indirect sales to customers in Asia. We derive a majority of our revenue from the sales of our DC to DC converter product family which services the Communications, Computing, Consumer and Industrial markets. We believe our ability to achieve revenue growth will depend, in part, on our ability to develop new products, enter new market segments, gain market share, manage litigation risk, diversify our customer base and successfully secure manufacturing capacity.

Critical Accounting Policies and Estimates

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

We believe the following critical accounting policies reflect our more significant judgments used in the preparation of our consolidated financial statements.

Revenue Recognition. We recognize revenue in accordance with Financial Accounting Standards Board ("FASB") – Accounting Standards Codification ("ASC") 605-10-S25 Revenue Recognition – Overall – Recognition. ASC 605-10-S25 requires that four basic criteria must be met before revenue can be recognized: (1) persuasive evidence of an arrangement exists; (2) delivery has occurred or services have been rendered; (3) the fee is fixed or determinable; and (4) collectability is reasonably assured. Determination of criteria (3) and (4) are based on management's judgment regarding the fixed nature of the fee charged for products delivered and the collectability of those fees. The application of these criteria has resulted in our generally recognizing revenue upon shipment (when title passes) to customers. Should changes in conditions cause management to determine these criteria are not met for certain future transactions, revenue recognized for any reporting period could be adversely impacted.

Approximately 81% of our sales for the six months ended June 30, 2012 were made through distributors with formal distribution agreements. These arrangements do not include any special payment terms (our normal payment terms are 30-45 days for our distributors), price protection or exchange rights. Returns are limited to our standard product warranty. Certain of our large distributors have contracts that include limited stock rotation rights that permit the return of a small percentage of the previous six months' purchases in return for a compensating new order of equal or greater dollar value.

Our revenue consists primarily of assembled and tested finished goods. We also sell die in wafer form to our customers and value-added resellers and receive royalty revenue from third parties and value-added resellers.

We maintain a sales reserve for stock rotation rights, which is based on historical experience of actual stock rotation returns on a per distributor basis, where available, and information related to products in the distribution channel. This reserve is recorded at the time of sale. In the future, if we are unable to estimate our stock rotation returns accurately, we may not be able to recognize revenue from sales to our distributors based on when we sell inventory to our distributors. Instead, we may have to recognize revenue when the distributor sells through such inventory to an end-customer.

We generally recognize revenue upon shipment of products to the distributor for the following reasons (based on ASC 605-15-25-1 Revenue Recognition – Products – Recognition – Sales of Products When Right of Return Exists):

(1) Our price is fixed or determinable at the date of sale. We do not offer special payment terms, price protection or price adjustments to distributors where we recognize revenue upon shipment
(2) Our distributors are obligated to pay us and this obligation is not contingent on the resale of our products
(3) The distributor's obligation is unchanged in the event of theft or physical destruction or damage to the products
(4) Our distributors have stand-alone economic substance apart from our relationship
(5) We do not have any obligations for future performance to directly bring about the resale of our products by the distributor
(6) The amount of future returns can be reasonably estimated. We have the ability and the information necessary to track inventory sold to and held at our distributors. We maintain a history of returns and have the ability to estimate the stock rotation returns on a quarterly basis.

If we enter into arrangements that have rights of return that are not estimable, we recognize revenue under such arrangements only after the distributor has sold our products to an end customer.

Approximately 8% of our sales for the six months ended June 30, 2012 were made through value-added resellers based on purchase orders rather than formal distribution arrangements. These value-added resellers do not receive any stock rotation rights and, as such, hold very little inventory, if any. We do not have a history of accepting returns from these value-added resellers.

The terms in a majority of our distribution agreements include the non-exclusive right to sell, and the agreement to use best efforts to promote and develop a market for, our products in certain regions of the world and the ability to terminate the distribution agreement by either party with up to three months notice. We provide a one year warranty against defects in materials and workmanship. Under this warranty, we will repair the goods, provide replacements at no charge, or, under certain circumstances, provide a refund to the customer for defective products. Estimated warranty returns and warranty costs are based on historical experience and are recorded at the time product revenue is recognized.

Two of the Company's U.S. distributors have distribution agreements where revenue is recognized upon sale by these distributors to their end customers because these distributors have certain rights of return which management believes are not estimable. The deferred revenue balance from these two distributors as of June 30, 2012 and December 31, 2011 was $1.7 million and $1.0 million, respectively.

Warranty Reserves. We currently provide a 12-month warranty against defects in materials and workmanship and will either repair the goods or provide replacement products at no charge to the customer for defective products. We record estimated warranty costs by product, which are based on historical experience over the preceding 12 months, at the time we recognize product revenue. Reserve requirements are recorded in the period of sale and are based on an assessment of the products sold with warranty and historical warranty costs incurred. As the complexity of our products increases, we could experience higher warranty claims relative to sales than we have previously experienced, and we may need to increase these estimated warranty reserves.

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

Accounting for Income Taxes. ASC 740-10 Income Taxes – Overall 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 and disclosure. In accordance with ASC 740-10, we recognize federal, state and foreign current tax liabilities or assets based on our estimate of taxes payable or refundable in the current fiscal year by tax jurisdiction. We also recognize federal, state and foreign deferred tax assets or liabilities for our estimate of future tax effects attributable to temporary differences and carryforwards. We record a valuation allowance to reduce any deferred tax assets by the amount of any tax benefits that, based on available evidence and judgment, are not expected to be realized.

Our calculation of current and deferred tax assets and liabilities is based on certain estimates and judgments and involves dealing with uncertainties in the application of complex tax laws. Our estimates of current and deferred tax assets and liabilities may change based, in part, on added certainty or finality or uncertainty to an anticipated outcome, changes in accounting or tax laws in the U.S., or foreign jurisdictions where we operate, or changes in other facts or circumstances. In addition, we recognize liabilities for potential U.S. and foreign income tax for uncertain income tax positions taken on our tax returns if it has less than a 50% likelihood of being sustained. If we determine that payment of these amounts is unnecessary or if the recorded tax liability is less than our current assessment, we may be required to recognize an income tax benefit or additional income tax expense in our financial statements in the period such determination is made. We have calculated our uncertain tax positions which were attributable to certain estimates and judgments primarily related to transfer pricing, cost sharing and our international tax structure exposure.

As of both June 30, 2012 and December 31, 2011, we had a valuation allowance of $14.6 million attributable to management’s determination that it is more likely than not that none of the deferred tax assets in the United States will be realized, except for certain deferred tax assets related to uncertain income tax positions. Should it be determined that all or part of the net deferred tax asset will not be realized in the future, an adjustment to increase the deferred tax asset valuation allowance will be charged to income in the period such determination is made. Likewise, in the event we were to determine that it is more likely than not that we would be able to realize our deferred tax assets in the future in excess of our net recorded amount, an adjustment to the valuation allowance for the deferred tax asset would increase income in the period such determination was made.

Contingencies. We and certain of our subsidiaries are parties to actions and proceedings incident to our business in the ordinary course of business, including litigation regarding our intellectual property, challenges to the enforceability or validity of our intellectual property and claims that our products infringe on the intellectual property rights of others. The pending proceedings involve complex questions of fact and law and will require the expenditure of significant funds and the diversion of other resources to prosecute and defend. In addition, from time to time, we become aware that we are subject to other contingent liabilities. When this occurs, we will evaluate the appropriate accounting for the potential contingent liabilities using ASC 450-20-25-2 Contingencies – Loss Contingencies - Recognition to determine whether a contingent liability should be recorded. In making this determination, management may, depending on the nature of the matter, consult with internal and external legal counsel and technical experts. Based on the facts and circumstances in each matter, we use our judgment to determine whether it is probable that a contingent loss has occurred and whether the amount of such loss can be estimated. If we determine a loss is probable and estimable, we record a contingent loss in accordance with ASC 450-20-25-2. In determining the amount of a contingent loss, we take into account advice received from experts for each specific matter regarding the status of legal proceedings, settlement negotiations (which may be ongoing), prior case history and other factors. Should the judgments and estimates made by management need to be adjusted as additional information becomes available, we may need to record additional contingent losses that could materially and adversely impact our results of operations. Alternatively, if the judgments and estimates made by management are adjusted, for example, if a particular contingent loss does not occur, the contingent loss recorded would be reversed which could result in a favorable impact on our results of operations.

Accounting for Stock-Based Compensation. We account for stock-based compensation under the provisions of ASC 718-10-30 Compensation – Stock Compensation – Overall – Initial Measurement. This standard requires us to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award. That cost will be recognized over the period during which an employee is required to provide services in exchange for the award, known as the requisite service period (usually the vesting period). We currently use the Black-Scholes option-pricing model to estimate the fair value of our share-based payments. The Black-Scholes option-pricing model is based on a number of assumptions, including historical volatility, expected life, risk-free interest rate and expected dividends. The amount of stock-based compensation that we recognize is also based on an expected forfeiture rate. If there is a difference between the forfeiture assumptions used in determining stock-based compensation costs and the actual forfeitures which become known over time, we may change the forfeiture rate, which could have a significant impact on our stock-based compensation expense.

Fair Value Instruments. ASC 820-10 Fair Value Measurements and Disclosures – Overall defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles in the United States of America, and requires that assets and liabilities carried at fair value be classified and disclosed in one of the three categories, as follows:

a. Level 1: Quoted prices in active markets for identical assets;
b. Level 2: Significant other observable inputs; and
c. Level 3: Significant unobservable inputs.

ASC 820-10-35-51 Fair Value Measurement and Disclosure – Overall – Subsequent Measurement – Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly provides additional guidance for estimating fair value in accordance with ASC 820-10 Fair Value Measurements and Disclosures – Overall, when the volume and level of activity for the asset or liability have significantly decreased.

Our financial instruments include cash and cash equivalents and short-term and long-term investments. Cash equivalents are stated at cost, which approximates fair market value. Short-term and long-term investments are stated at their fair market value.

The face value of our holdings in auction rate securities is $12.3 million, all of which is classified as long-term available-for-sale investments.

Investments in available-for-sale securities are recorded at fair value, and unrealized gains or losses (that are deemed to be temporary) are recognized through shareholders' equity, as a component of accumulated other comprehensive income in our condensed consolidated balance sheet and in our condensed consolidated statement of comprehensive income. We record an impairment charge to earnings when an available-for-sale investment has experienced a decline in value that is deemed to be other-than-temporary.

We adopted the provisions of ASC 320-10-35 Investments – Debt and Equity Securities – Overall – Subsequent Measurement and ASC 320-10-50 Investments – Debt and Equity Securities – Overall - Disclosure, effective April 1, 2009 and used the guidelines therein to determine whether the impairment is temporary or other-than temporary. Other-than-temporary impairment charges exist when the entity has the intent to sell the security or it will more likely than not be required to sell the security before anticipated recovery. During the year ended December 31, 2009, we recognized a credit loss of $70,000, which was deemed to be other-than-temporary in other income (expense) in our Condensed Consolidated Statement of Operations. There have been no such losses since.

Based on certain assumptions described in Note 8, “Fair Value Measurements”, to our condensed consolidated financial statements and the Liquidity and Capital Resources section of “Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations” of this quarterly report on Form 10-Q, we recorded impairment charges on our holdings in auction-rate securities. The valuation of these securities is subject to fluctuations in the future, which will depend on many factors, including the collateral quality, potential to be called or restructured, underlying final maturity, insurance guaranty, liquidity and market conditions, among others.

Results of Operations

The table below sets forth the data from our Condensed Consolidated Statement of Operations as a percentage of revenue for the periods indicated:

	Three months ended June 30,				Six months ended June 30,			
	2012		2011		2012		2011	
Revenue	100.0	%	100.0	%	100.0	%	100.0	%
Cost of revenue	46.8	%	48.6	%	47.2	%	49.2	%
Gross profit	53.2	%	51.4	%	52.8	%	50.8	%
Operating expenses:								
Research and development	21.3	%	21.8	%	21.6	%	22.2	%
Selling, general and administrative	20.8	%	20.0	%	22.1	%	20.6	%
Litigation expense (benefit)	(0.4	%)	1.8	%	(0.1	%)	1.8	%
Total operating expenses	41.7	%	43.6	%	43.6	%	44.6	%
Income from operations	11.5	%	7.8	%	9.2	%	6.2	%
Interest income and other, net	0.6	%	0.1	%	0.4	%	0.2	%
Income before income taxes	12.1	%	7.9	%	9.6	%	6.4	%
Income tax provision / (benefit)	0.9	%	1.2	%	0.8	%	0.8	%
Net income	11.2	%	6.7	%	8.8	%	5.6	%

Revenue.

	For the three months ended June 30,				For the six months ended June 30,			
	2012	2011			2012	2011		
	(in thousands)		Change		(in thousands)		Change	
Revenue	$ 58,607	$ 51,628	13.5	%	$ 109,091	$ 96,096	13.5	%

Revenue for the three months ended June 30, 2012 was $58.6 million, an increase of $7.0 million, or 13.5%, from $51.6 million for the three months ended June 30, 2011. This increase was primarily due to increased demand for our DC to DC converters. Revenue from our DC to DC converters of $51.2 million increased $6.4 million, or 14.3% in 2012 compared to the same period in 2011 primarily due to a demand driven increase in unit product shipment for our DCDC and Mini-Monster products. Sales of our lighting control products for the three months ended June 30, 2012 was up by 8.5% compared to the same period in 2011.

Revenue for the six months ended June 30, 2012 was $109.1 million, an increase of $13.0 million, or 13.5%, from $96.1 million for the six months ended June 30, 2011. This increase was primarily due to increased demand for our DC to DC converters. The revenue from our DC to DC converters was $95.5 million, an increase of $12.2 million, or 14.6% compared to the same period in 2011. The revenue increase in DC to DC converter product line was primarily driven by increased demand for our DCDC and Mini-Monster products. For the first six months of 2012, sales of our lighting control products were up 6.6% year over year.

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

	For the three months ended June 30,					For the six months ended June 30,				
	2012		2011			2012		2011		
	(in thousands) Amount	% of Revenue	(in thousands) Amount	% of Revenue	Change	(in thousands) Amount	% of Revenue	(in thousands) Amount	% of Revenue	Change
DC to DC Converters	51,165	87.3 %	$ 44,771	86.7 %	14.3 %	95,507	87.5 %	$ 83,351	86.7 %	14.6 %
Lighting Control Products	7,442	12.7 %	6,857	13.3 %	8.5 %	13,584	12.5 %	12,745	13.3 %	6.6 %
	$ 58,607	100.0 %	$ 51,628	100.0 %	13.5 %	$ 109,091	100.0 %	$ 96,096	100.0 %	13.5 %

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Cost of Revenue and Gross Margin.

	For the three months ended June 30,			For the six months ended June 30,		
	2012	2011		2012	2011	
	(in thousands)		Change	(in thousands)		Change
Cost of Revenue (1)	$ 27,435	$ 25,070	9.4 %	$ 51,509	$ 47,233	9.1 %
Cost of revenue as a percentage of revenue	46.8 %	48.6 %		47.2 %	49.2 %	
Gross Profit	$ 31,172	26,558	17.4 %	$ 57,582	48,863	17.8 %
Gross Margin	53.2 %	51.4 %		52.8 %	50.8 %	
(1) Includes stock-based compensation expense	$ 118	$ 89		$ 213	$ 152	

Cost of revenue consists primarily of costs incurred to manufacture, assemble and test our products, as well as other overhead costs relating to the aforementioned costs including stock-based compensation expense. Gross Profit as a percentage of revenue, or gross profit margin, was 53.2% for the three months ended June 30, 2012 and 51.4% for the three months ended June 30, 2011. Gross profit as a percentage of revenue, or gross profit margin, was 52.8% for the six months ended June 30, 2012 and 50.8% for the six months ended June 30, 2011. The respective 1.8 and 2.0 percentage point increases, in gross profit margin for the three and six months ended June 30, 2012 were primarily due to cost efficiency and higher absorption of in-house test manufacturing overhead on higher revenue, lower relative costs for Inventory and warranty reserves, and better product mix compared to the same periods in 2011.

Research and Development.

	For the three months ended June 30,			For the six months ended June 30,		
	2012	2011		2012	2011	
	(in thousands)		Change	(in thousands)		Change
Research and development (“R&D”) (1)	$ 12,468	$ 11,237	11.0 %	$ 23,586	$ 21,323	10.6 %
R&D as a percentage of revenue	21.3 %	21.8 %		21.6 %	22.2 %	
(1) Includes stock-based compensation expense	$ 1,524	$ 1,550		$ 2,790	$ 2,977	

R&D expenses consist of salary and benefit expenses for design and product engineers, expenses related to new product development, and related facility costs. R&D expenses were $12.5 million or 21.3% of revenue, for the three months ended June 30, 2012 and $11.2 million, or 21.8% of revenue, for the three months ended June 30, 2011. R&D expenses were $23.6 million or 21.6% of revenue, for the six months ended June 30, 2012 and $21.3 million, or 22.2% of revenue, for the six months ended June 30, 2011. R&D expenses increased year-over-year due to an increase in personnel-related costs, increase in facilities costs related to moving expenses associated with our new headquarter location and costs associated with new product development. Our R&D head count as of June 30, 2012 was 388 employees as compared to 379 employees as of June 30, 2011.

Selling, General and Administrative.

	For the three months ended June 30,			For the six months ended June 30,		
	2012	2011		2012	2011	
	(in thousands)		Change	(in thousands)		Change
Selling, general and administrative ("SG&A") (1)	$12,167	$10,343	17.6 %	$24,133	$19,833	21.7 %
SG&A as a percentage of revenue	20.8 %	20.0 %		22.1 %	20.6 %	
(1) Includes stock-based compensation expense	$2,187	$2,036		$4,141	$3,533	

SG&A expenses include salary and benefit expenses for sales, marketing and administrative personnel, sales commissions, travel expenses, related facilities costs, outside legal and accounting fees, and fees associated with Sarbanes-Oxley compliance requirements. SG&A expenses were $12.2 million, or 20.8% of revenue, for the three months ended June 30, 2012 and $10.3 million, or 20.0% of revenue for the three months ended June 30, 2011. SG&A expenses were $24.1 million, or 22.1% of revenue, for the six months ended June 30, 2012 and $19.8 million, or 20.6% of revenue, for the six months ended June 30, 2011. For the three and six months ended June 30, 2012, SG&A expenses increased year over year due to an increase in personnel-related costs, sales commission and stock-based compensation expense. Our SG&A head count as of June 30, 2012 were 248 employees as compared to 233 employees as of June 30, 2011.

Litigation Expense.

	For the three months ended June 30, 2012	2011	Change	For the six months ended June 30, 2012	2011	Change
	(in thousands)			(in thousands)		
Litigation expense	$ (244)	$ 939	(126.0)%	$ (116)	$ 1,752	(106.6)%
Litigation expense as a percentage of revenue	-0.4 %	1.8 %		-0.1 %	1.8 %	

Litigation expenses (benefit) were ($0.2) million, or (0.4%) of revenue, for the three months ended June 30, 2012, compared to $0.9 million, or 1.8% of revenue, for the three months ended June 30, 2011. Litigation expenses were ($0.1) million or (0.1%) of revenue, for the six months ended June 30, 2012, compared to $1.8 million, or 1.8% of revenue, for the six months ended June 30, 2011. This decrease was primarily due to lower litigation spending in 2012 compared to the same period in 2011, plus the benefit of a $0.3 million and $0.6 million of payments received under a settlement and license agreement for the three and six months ended June 30, 2012, respectively. In December 2011, the Company entered into a settlement agreement with a third-party company for infringement of the Company's patent whereby the Company will receive a total of $2 million which will be paid in equal installments of $300,000 in each quarter of 2012 and the remainder will be paid in two equal installments in the first two quarters of 2013. For the three and six months ended June 30, 2012, the Company received $0.3 million and $0.6 million payments, respectively, which were recorded as credits to litigation expenses in the Condensed Consolidated Statements of Operations. During the three and six months ended June 30, 2011, we incurred legal expenses primarily to recover attorneys' fees from O2Micro relating to our lawsuits involving O2Micro, which were resolved in the second quarter of 2010. Overall, our litigation expense has decreased as a result of MPS being party to fewer material litigations.

Income Tax Provision. The income tax provision for the three and six months ended June 30, 2012 was $0.5 million or 7.7% of the Company's income before income taxes and $0.9 million, or 8.2% of the pre-tax income, respectively. This differs from the federal statutory rate of 34% primarily because the Company's foreign income was taxed at lower rates and because of the benefit that the Company realized as a result of stock option exercises and restricted units vested. The income tax provision for the three and six months ended June 30, 2011 was $0.6 million or 14.3% of our income before income taxes and $0.8 million, or 12.8% of pre-tax income, respectively. This differs from the federal statutory rate of 34% primarily because our foreign income was taxed at lower rates and because of the benefit that we realized as a result of restricted units released.

Liquidity and Capital Resources.

	June 30, 2012	December 31, 2011
	(In thousands)	
Cash and cash equivalents	$81,644	$96,371
Short-term investments	103,013	77,827
Total cash, cash equivalents and short-term investments	$184,657	$174,198
Percentage of total assets	59.6 %	63.6 %
Total current assets	$238,151	$211,505
Total current liabilities	(35,584)	(26,070)

Working Capital	$202,567	$185,435

As of June 30, 2012, we had working capital of $202.6 million, including cash and cash equivalents of $81.6 million and short-term investments of $103.0 million, compared to working capital of $185.4 million, including cash and cash equivalents of $96.4 million and short-term investments of $77.8 million as of December 31, 2011. For the six months ended June 30, 2012, cash and cash equivalents decreased by $14.8 million primarily due to investment in short-term securities and cash used to pay for the cost of building improvements at our new headquarters located in San Jose, California. We have financed our operations primarily with proceeds from cash generated from operating activities, proceeds from the exercise of stock options and proceeds from the issuance of shares through the Company’s employee stock purchase plan. As of June 30, 2012, $41.4 million of the $81.6 million of cash and cash equivalents and $16.0 million of the $103.0 million of short-term investments were held by our international subsidiaries. If these funds are needed for our operations in the U.S., we may be required to accrue and pay U.S. taxes to repatriate these funds. However, our intent is to indefinitely reinvest these funds outside of the U.S. and our current plans do not demonstrate a need to repatriate them to fund our U.S. operations.

The significant components of our working capital are cash and cash equivalents, short-term investments, accounts receivable, inventories, deferred income taxes and prepaid expenses and other current assets, reduced by accounts payable, accrued and other current liabilities, deferred revenue and customer prepayments.

Working capital at June 30, 2012 increased by $17.2 million compared to the working capital at December 31, 2011, primarily due to a $26.6 million net increase in current assets offset a by $9.5 million net increase in current liabilities. The increase in current assets was primarily due to investment in short-term securities and an increase in inventories to meet the anticipated future demand. In addition, accounts receivable increased reflecting a change in the timing of shipments during the quarter relative to the fourth quarter of 2011. The increase in current liabilities was primarily due to an increase in accounts payable.

Summary of Cash Flows. The table below summarizes the cash and cash equivalents provided by (used in) in our operating, investing and financing activities for the periods presented:

	Six months ended June 30,	
	2012	2011
	(Dollars in thousands)	
Cash provided by operating activities	12,292	21,514
Cash provided by (used in) investing activities	(36,327)	60,591
Cash provided by (used in) financing activities	9,144	(32,808)
Effect of exchange rate changes on cash and cash equivalents	164	378
Net increase (decrease) in cash and cash equivalents	(14,727)	49,675

For the six months ended June 30, 2012, net cash provided by operating activities was $12.3 million, primarily reflecting strong operating results and an increase in accounts payable in support of both our building improvements for our new headquarters and inventory purchases. This was partially offset by an increase in accounts receivable resulting from the timing of shipments relative to the fourth quarter of 2011 for which the collections have not been made and increase in inventories. For the six months ended June 30, 2011, net cash provided by operating activities was $21.5 million primarily due to strong operating results and an increase in accounts payable for inventory purchases. This was partially offset by an increase in inventories to meet the anticipated future demand and an increase in accounts receivable resulting from shipments at the end of the quarter for which the collections had not been made.

For the six months ended June 30, 2012, net cash used in investing activities was $36.3 million, primarily related to the investment in short-term securities and investment in building improvements at our new headquarters location in San Jose, California. For the six months ended June 30, 2011, net cash provided by investing activities was $60.6 million, primarily related to the redemption of short-term investments to fund our stock repurchase program.

We use professional investment management firms to manage the majority of our invested cash. Our fixed income portfolio is primarily invested in US government securities, auction-rate securities and highly rated corporate notes and commercial paper. The balance of the fixed income portfolio is managed internally and invested primarily in money market securities for working capital purposes.

We adopted the provisions of ASC 320-10-35 Investments – Debt and Equity Securities – Overall – Subsequent Measurement and ASC 320-10-50 Investments – Debt and Equity Securities – Overall - Disclosure, effective April 1, 2009 and used the guidelines therein to determine whether the impairment is temporary or other-than temporary. Temporary impairment charges are recorded in accumulated other comprehensive income (loss) within equity and has no impact on net income. Other-than-temporary impairment charges exist when the entity has the intent to sell the security, it will more likely than not be required to sell the security before anticipated recovery, or it does not expect to recover the entire amortized cost basis of the security. Other-than-temporary impairment charges are recorded in other income (expenses) in the Condensed Consolidated Statement of Operations.

At June 30, 2012, the Company’s investment portfolio included $11.7 million in government-backed student loan auction-rate securities, net of impairment charges of $0.56 million; of which, $0.53 million was temporary and $0.03 million was recorded other-than-temporary. This compares to an investment balance of auction-rate securities as of December 31, 2011 of $13.7 million, net of impairment charges of $0.7 million; of which, $0.6 million was temporary and $0.1 million was recorded as other-than-temporary. The underlying maturity of these auction-rate securities is up to 35 years. As of June 30, 2012 and December 31, 2011 the portion of the impairment classified as temporary was based on the following analysis:

1. The decline in the fair value of these securities is not attributable to adverse conditions specifically related to these securities or to specific conditions in an industry or in a geographic area;
2. Management possesses both the intent and ability to hold these securities for a period of time sufficient to allow for any anticipated recovery in fair value;

3. Management believes that it is more likely than not that the Company will not have to sell these securities before recovery of its cost basis;
4. Except for the credit loss of $70,000 recognized in year ended December 31, 2009 for the Company's holdings in auction rate securities described below, the Company does not believe that there is any additional credit loss associated with other auction-rate securities because the Company expects to recover the entire amortized cost basis;
5. The face value of $6.0 million of the auction-rate securities remain AAA rated and the face value of $6.3 million of the auction rate securities having been downgraded by Moody's to A3-Baa3 during the year ended December 31, 2009, and there have been no downgrades since; and
6. All scheduled interest payments have been made pursuant to the reset terms and conditions; and
7. All redemptions of auction-rate securities representing 68% of the original portfolio purchased by the Company in February 2008 have been at par.

Based on the guidance of ASC 320-10-35 and ASC 320-10-50, the Company evaluated the potential credit loss of each of the auction-rate securities that are currently held by the Company. Based on such analysis, the Company determined that those securities that are not 100% FFELPS guaranteed are potentially subject to credit risks based on the extent to which the underlying debt is collateralized and the security-specific student-loan default rates. The Company's portfolio includes two such securities. The senior parity ratio for the two securities is approximately 106%. If, therefore, the student-loan default rate and borrowing rate increases for these issuers, the remaining balance in these trusts may not be sufficient to cover the senior debt. The Company therefore concluded that there is potential credit risk for these two securities and as such, used the discounted cash flow model to determine the amount of credit loss to be recorded. In valuing the potential credit loss, the following parameters were used: 2.0 year expected term, cash flows based on the 90-day t-bill rates for 2.0 year forwards and a risk premium of 5.9%, the amount of interest that the Company was receiving on these securities when the market was last active. During the year ended December 31, 2009, the potential credit loss associated with these securities was $70,000, which the Company deemed other-than-temporary and recorded in other expense in its Consolidated Statement of Operations during 2009. There have been no such losses since. During the three months ended June 30, 2012, the Company was able to redeem one of these two securities at par and therefore, recognized a gain of $40,000 in other expense in its Consolidated Statement of Operations.

Unless a rights offering or other similar offer is made to redeem at par and accepted by us, we intend to hold the balance of these investments through successful auctions at par, which we believe could take approximately 2.0 years.

Determining the fair value of the auction-rate securities requires significant management judgment regarding projected future cash flows which will depend on many factors, including the quality of the underlying collateral, estimated time for liquidity including potential to be called or restructured, underlying final maturity, insurance guaranty and market conditions, among others. To determine the fair value of the auction-rate securities at December 31, 2011 and June 30, 2012, the Company used a discounted cash flow model, for which there are four unobservable inputs: estimated time-to-liquidity, discount rate, credit quality of the issuer and expected interest receipts. A significant increase in the time-to-liquidity or the discount rate inputs or a significant decrease in the credit quality of the issuer or the expected interest receipts inputs in isolation would result in a significantly lower fair value measurement.

The following are the values used in the discounted cash flow model:

June 30, 2012

		December 31, 2011
Time-to-Liquidity	24 months	24 months
Expected Return (Based on the requisite treasury rate, plus a contractual penalty rate)	1.8%	1.8%
Discount Rate (Based on the requisite LIBOR, the cost of debt and a liquidity risk premium) and (depending on the credit-rating of the security)	2.6% - 7.4%	3.1% - 7.9%

From the fourth quarter of 2011 to the first and second quarter of 2012, we kept the time-to-liquidity constant at 2.0 years. We sold $2.1 million in auction-rate securities at par and reversed the impairment related to these securities in the amount of $0.1 million. This reduced the overall impairment from $0.7 million at December 31, 2011 to $0.6 million at June 30, 2012.

Net cash provided by financing activities for the six months ended June 30, 2012 was $9.1 million, primarily from the proceeds from the exercise of stock options in the amount of $7.3 million and proceeds from the employee stock purchase plan of $1.0 million. Net cash used in financing activities for the six months ended June 30, 2011 was $32.8 million, primarily due to stock repurchases in the amount of $38.5 million, which was partially offset by the proceeds from the exercise of stock options in the amount of $4.3 million and proceeds from the employee stock purchase plan of $0.9 million.

On July 27, 2010, we announced that our Board of Directors approved a stock repurchase program that authorized the Company to repurchase up to $50.0 million of its common stock between August 2, 2010 and December 31, 2011. From August 2010 through June 2011, we repurchased 4,385,289 shares for a total of $70.0 million. In February 2011, our Board of Directors approved an increase from $50.0 million to $70.0 million. During the six months ended June 30, 2011, the following shares have been repurchased through the open market and subsequently retired:

2011 Calendar Year	Shares Repurchased	Average Price Per Share		Value (in thousands)	
February	817,500	$	15.47	$	12,648
March	75,000	$	14.17	$	1,062
April	917,200	$	14.82	$	13,617
May	657,800	$	16.48	$	10,843
June	18,000	$	16.79	$	302
	2,485,500			$	38,472

Although cash requirements will fluctuate based on the timing and extent of many factors such as those discussed above, we believe that cash generated from operations, together with the liquidity provided by existing cash and cash equivalents and short-term investments, will be sufficient to satisfy our liquidity requirements for at least the next 12 months. For further details regarding our operating, investing and financing activities, see our Condensed Consolidated Statements of Cash Flows.

Contractual Obligations and Off Balance Sheet Arrangements.

In May 2012, we moved from our previous headquarters in San Jose, California to our current Company-owned headquarters also located in San Jose, California.

Certain of our facility leases provide for periodic rent increases. In September 2004, we signed an agreement with the Chinese local authority to construct a facility in Chengdu, China. We have the option to acquire this facility in Chengdu after a five-year lease term, which option became exercisable in March 2011. We will likely exercise our purchase option and enter into a purchase agreement for this facility in the future. We constructed a 150,000 square foot research and development facility in Chengdu, China which was put into operation in October 2010.

We also lease our sales offices in Japan, China, Taiwan, and Korea.

Our other contractual obligations have not changed significantly from that disclosed in our annual report on Form 10-K filed with the SEC on March 12, 2012.

As of June 30, 2012, we had no off-balance sheet arrangements as defined in Item 303(a)(4) of the Securities and Exchange Commission’s Regulation S-K.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

For a discussion of market risks at December 31, 2011, refer to Item 7A, “Quantitative and Qualitative Disclosures about Market Risk” in our annual report on Form 10-K for the fiscal year ended December 31, 2011 filed with the SEC on March 12, 2012. During the six months ended June 30, 2012, there were no material changes or developments that would materially alter the market risk assessment performed as of December 31, 2011.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of disclosure controls and procedures.

Our management, with the participation of our chief executive officer and chief financial officer, evaluated the effectiveness of our disclosure controls and procedures pursuant to Rule 13a-15 under the Securities Exchange Act of 1934 as of the end of the period covered by this quarterly report on Form 10-Q. In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives. In addition, the design of disclosure controls and procedures must reflect the fact that there are resource constraints and that management is required to apply its judgment in evaluating the benefits of possible controls and procedures relative to their costs.

Based on our evaluation, our chief executive officer and chief financial officer concluded that our disclosure controls and procedures are designed at a reasonable assurance level and are effective to provide reasonable assurance that information we are required to disclose in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms, and that such information is accumulated and communicated to our management, including our chief executive officer and chief financial officer, as appropriate, to allow timely decisions regarding required disclosure.

Changes in internal control over financial reporting.

There were no changes in our internal control over financial reporting that occurred during the period covered by this quarterly report on Form 10-Q that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

On September 16, 2011 and September 29, 2011, two nearly identical shareholder derivative actions were filed in the United States District Court for the Northern District of California and the California Superior Court for Santa Clara County, naming as defendants certain of the Company’s current and former directors and officers and the Company’s compensation advisory firm. The complaints asserted claims for, among other things, breach of fiduciary duty in connection with the directors' approval of compensation for the Company's executive officers during 2010. The complaints each sought an award of damages in favor of the Company, equitable relief, costs and attorney's fees. On March 2, 2012, the parties in the state court action stipulated to the dismissal without prejudice of that action. On April 3, 2012, a hearing was held in the United States District Court on the defendants’ motions to dismiss the case. On June 13, 2012, the United States District Court issued an order granting the motions and dismissing the complaint without prejudice. The court ruled that the plaintiff had failed to sufficiently allege that pre-suit demand on the Company’s board of directors was excused, and granted the plaintiff leave to amend the complaint. The plaintiff subsequently informed the defendants that it did not intend to amend the complaint. On July 9, 2012, the parties in the federal court action stipulated to the dismissal without prejudice of that action, and on July 10, 2012, the federal court signed an order dismissing the action without prejudice.

On May 3, 2012, the United States District Court for the Northern District of California issued an order finding O2 Micro International, Ltd. (“O2 Micro”) liable for approximately $9.1 million in attorneys’ fees and non-taxable costs, plus interest, in connection with the patent litigation that the Company won in 2010. This award is in addition to the approximately $340,000 in taxable costs that the Court had earlier ordered O2 Micro to pay to the Company in connection with the same lawsuit. O2 Micro filed complaints against the Company in both the United States International Trade Commission (“ITC”) and the Northern District of California, alleging that the Company infringed four O2 Micro patents but then voluntarily dismissed three patents. In June 2010, the ITC found that the Company's products did not infringe O2 Micro’s patent. Subsequently, O2 Micro unilaterally dismissed its infringement claims with prejudice, and granted the Company and its customers broad covenants not to sue in the district court case. On March 3, 2011, the Court ordered O2 Micro to pay the Company $339,315.13 in costs. The Court also found that “O2 Micro engaged in a vexatious litigation strategy and litigation misconduct,” entitling the Company to its reasonable attorneys' fees. O2 Micro's vexatious litigation strategy consisted of filing lawsuits against the Company and its customers; only to dismiss them after substantial litigation had taken place. This allowed O2 Micro to damage the Company's business while avoiding trials at which the validity of its patents would be challenged. Since that time, the Company submitted the documentation for its attorneys’ fees and non-taxable costs. O2 Micro challenged those fees on various grounds. On May 3, 2012, the Court accepted the Company’s figures and entered an order awarding $8,419,429 in attorneys’ fees, and $663,151 in non-taxable costs, plus interest. The Court then entered judgment for the Company. The Company anticipates that O2 Micro will appeal the Court’s orders and the final judgment. These amounts will be recognized in the Consolidated Financial Statements of the Company when all related appeals have been exhausted and collectability is probable.

We and certain of our subsidiaries are parties to actions and proceedings incident to our business in the ordinary course of business, including litigation regarding our intellectual property, challenges to the enforceability or validity of our intellectual property and claims that our products infringe on the intellectual property rights of others. These proceedings often involve complex questions of fact and law and will require the expenditure of significant funds and the diversion of other resources to prosecute and defend. We defend ourselves vigorously against any such claims.

In December 2011, the Company entered into a settlement and license agreement with a third-party company for infringement of the Company's patent whereby the Company will receive a total of $2 million which will be paid in equal installments of $300,000 in each quarter of 2012 and the remainder will be paid in two equal installments in the first two quarters of 2013. For the three and six months ended June 30, 2012, the Company received $0.3 million and $0.6 million payments, respectively, which were recorded as credits to litigation expenses in the Condensed Consolidated Statements of Operations.

ITEM 1A. RISK FACTORS

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

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

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

- our results of operations and financial performance;
- general economic, industry and global market conditions;
- whether our forward guidance meets the expectations of our investors;
- the depth and liquidity of the market for our common stock;
- developments generally affecting the semiconductor industry;
- commencement of or developments relating to our involvement in litigation;
- investor perceptions of us and our business strategies;
- changes in securities analysts' expectations or our failure to meet those expectations;
- actions by institutional or other large stockholders;
- terrorist acts or acts of war;

actual or anticipated fluctuations in our results of operations;

developments with respect to intellectual property rights;

announcements of technological innovations or significant contracts by us or our competitors;

introduction of new products by us or our competitors;

our sale of common stock or other securities in the future;

conditions and trends in technology industries;

changes in market valuation or earnings of our competitors;

our ability to develop new products, enter new market segments, gain market share, manage litigation risk, diversify our customer base and successfully secure manufacturing capacity;

our ability to increase our gross margins; and

changes in the estimation of the future size and growth rate of our markets.

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

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

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

a deterioration in general demand for electronic products as a result of worldwide financial crises and associated macro-economic slowdowns;

a deterioration in business conditions at our distributors, value-added resellers and/or end-customers;

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

the timing of developments and related expenses in our litigation matters;

the possibility of additional lost business as a result of customer and prospective customer concerns about adverse outcomes in our litigations or about being litigation targets;

continued dependence on our turns business (orders received and shipped within the same fiscal quarter);

increases in assembly costs due to commodity price increases, such as the price of gold;

the timing of new product introductions by us and our competitors;

the acceptance of our new products in the marketplace;

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

our ability to meet customer product demand in a timely manner;

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

the cyclical nature of demand for our customers' products;

an increase in stock rotation reserves;

our ability to manage our inventory levels, including the levels of inventory held by our distributors;

inventory levels and product obsolescence;

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

the availability of adequate manufacturing capacity from our outside suppliers;

- increases in prices for finished wafers due to general capacity shortages;
- the potential loss of future business resulting from current capacity issues;
- changes in manufacturing yields;
- movements in exchange rates, interest rates or tax rates; and
- determining the probability of accounting charges associated with performance-based equity awards granted to our employees

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

We may not be profitable on a quarterly or annual basis.

Our profitability is dependent on many factors, including:

- our sales, which because of our turns business (i.e., orders received and shipped within the same fiscal quarter), is difficult to accurately forecast;
- consumer electronic sales, which have experienced and may continue to experience a downturn as a result of the worldwide economic crisis;
- our competition, which could adversely impact our selling prices and our potential sales;
- our manufacturing costs, including our ability to negotiate with our vendors and our ability to efficiently run our test facility in China;
- manufacturing capacity constraints;
- determining the probability and magnitude of stock compensation accounting charges; and
- our operating expenses, including general and administrative expenses, selling and marketing expenses, stock-based compensation expenses, litigation expenses, and research and development expenses relating to products that will not be introduced and will not generate revenue until later periods, if at all.

We may not achieve profitability on a quarterly or annual basis in the future. Unfavorable changes in our operations, including any of the factors noted above, may have a material adverse effect on our quarterly or annual profitability.

For example, due to product shortages early in 2010, several major customers in Korea sought alternative suppliers, which impacted our full year revenue in 2011, our year to date revenue in 2012 and may continue to impact our revenue in future periods. If we are unable to find alternative sources of revenue to offset this source of lost revenue, our profitability may be impacted, which could materially and adversely affect our stock price and results of operations.

We may not experience growth rates comparable to past years.

In the past, our revenues increased significantly in certain years due to increased sales of certain of our products. Due to various factors, including increased competition, loss of certain of our customer install base, unfavorable changes in our operations, reduced global electronics demand, end-customer market downturn, market acceptance and penetration of our current and future products and ongoing litigation, we may not experience growth rates comparable to past periods, which could materially and adversely affect our stock price and results of operations.

We may be unsuccessful in developing and selling new products with margins similar to or better than what we have experienced in the past, which would impact our overall gross margin and financial performance.

Our success depends on products that are differentiated in the market, which result in gross margins that have historically been above the industry averages. Should we fail to improve our gross margin in the future, and accordingly develop and introduce sufficiently differentiated products that result in higher gross margins than industry averages, our financial condition could be materially adversely affected.

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

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

If demand for our products declines in the major end markets that we serve, our revenue will decrease and our results of operations and financial condition would be materially and adversely affected.

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

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

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

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

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

- timely and efficient completion of process design and device structure improvements;
- timely and efficient implementation of manufacturing, assembly, and test processes;
- the ability to secure and effectively utilize fabrication capacity in different geometries;
- product performance;
- product availability;
- the quality and reliability of the product; and
- effective marketing, sales and service.

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

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

We derive most of our revenue from customers located in Asia through direct or indirect sales through distribution arrangements with parties located in Asia. As a result, we are subject to increased risks due to this geographic concentration of business and operations. For the quarter ended June 30, 2012, approximately 91% of our revenue was from customers in Asia. There are risks inherent in doing business in Asia, and internationally in general, including:

- changes in, or impositions of, legislative or regulatory requirements, including tax laws in the United States and in the countries in which we manufacture or sell our products;
- trade restrictions, including restrictions imposed by the United States government on trading with parties in foreign countries;
- currency exchange rate fluctuations impacting intra-company transactions;
- transportation delays;
- changes in tax regulations in China that may impact our tax status in Chengdu;
- multi-tiered distribution channels that lack visibility to end customer pricing and purchase patterns;
- international political relationships and threats of war;
- terrorism and threats of terrorism;
- epidemics and illnesses;
- work stoppages and infrastructure problems due to adverse weather conditions or natural disasters;
- work stoppages related to employee dissatisfaction;
- economic and political instability;
- changes in import/export regulations, tariffs, and freight rates;
- longer accounts receivable collection cycles and difficulties in collecting accounts receivables;
- enforcing contracts generally; and
- less effective protection of intellectual property and contractual arrangements.

If we fail to expand our customer base and significantly reduce the geographical concentration of our customers, we will continue to be subject to the foregoing risks, which could materially and adversely affect our revenue and financial condition.

We are subject to anti-corruption laws in the jurisdictions in which we operate, including the U.S. Foreign Corrupt Practices Act, or the FCPA. Our failure to comply with these laws could result in penalties which could harm our reputation and have a material adverse effect on our business, results of operations and financial condition.

We are subject to the FCPA, which generally prohibits companies and their intermediaries from making improper payments to foreign officials for the purpose of obtaining or keeping business and/or other benefits, along with various other anticorruption laws. Although we have implemented policies and procedures designed to ensure that we, our employees and other intermediaries comply with the FCPA and other anticorruption laws to which we are subject, there is no assurance that such policies or procedures will work effectively all of the time or protect us against liability under the FCPA or other laws for actions taken by our employees and other intermediaries with respect to our business or any businesses that we may acquire. We have significant operations in Asia, which places us in frequent contact with persons who may be considered “foreign officials” under the FCPA, resulting in an elevated risk of potential FCPA violations. If we are not in compliance with the FCPA and other laws governing the conduct of business with government entities (including local laws), we may be subject to criminal and civil penalties and other remedial measures, which could have an adverse impact on our business, financial condition, results of operations and liquidity. Any investigation of any potential violations of the FCPA or other anticorruption laws by U.S. or foreign authorities could harm our reputation and have an adverse impact on our business, financial condition and results of operations.

We receive a significant portion of our revenue from distribution arrangements, value-added resellers and direct customers, and the loss of any one of these distributors, value-added resellers or direct customers or failure to collect a receivable from them could adversely affect our operations and financial position.

We market our products through distribution arrangements and value-added resellers and through our direct sales and applications support organization to customers that include OEMs, ODMs and electronic manufacturing service providers. Receivables from our customers are generally not secured by any type of collateral and are subject to the risk of being uncollectible. For the quarter ended June 30, 2012, sales to our largest two distributors accounted for approximately 29% of our total revenue. Significant deterioration in the liquidity or financial condition of any of our major customers or any group of our customers could have a material adverse impact on the collectability of our accounts receivable and our future operating results. We primarily conduct our sales on a purchase order basis, and we do not have any long-term supply contracts.

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

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

Because we provide components for end products and systems, demand for our products is influenced by our customers’ end product demand. As a result, we may have difficulty in accurately forecasting our revenue and expenses. Our revenue depends on the timing, size, and speed of commercial introductions of end products and systems that incorporate our products, all of which are inherently difficult to forecast, as well as the ongoing demand for previously introduced end products and systems. In addition, demand for our products is influenced by our customers’ ability to manage their inventory. Our sales to distributors are subject to higher volatility because they service demand from multiple levels of the supply chain which, in itself, is inherently difficult to forecast. Specifically, in the fourth quarter of 2010, demand was lower because distributors used up inventory that was shipped in the third quarter. If our customers, including distributors, do not manage their inventory correctly or misjudge their customers’ demand, our shipments to and orders from our customers may vary significantly on a quarterly basis.

Our ability to increase product sales and revenues may be constrained by the manufacturing capacity of our suppliers.

Although we provide our suppliers with rolling forecasts of our production requirements, their ability to provide wafers to us is limited by the available capacity, particularly capacity in the geometries we require, at the facilities in which they manufacture wafers for us. As a result, this lack of capacity has constrained our product sales and revenue growth. In addition, an increased need for capacity to meet internal demands or demands of other customers could cause our suppliers to reduce capacity available to us. Our suppliers may also require us to pay amounts in excess of contracted or anticipated amounts for wafer deliveries or require us to make other concessions in order to acquire the wafer supply necessary to meet our customer requirements. If our suppliers extend lead times, limit supplies or the types of capacity we require, or increase prices due to capacity constraints or other factors, our revenue and gross margin may materially decline. In addition, if we experience supply delays or limitations, our customers may reduce their purchase levels with us and/or seek alternative solutions to meet their demand, which could materially and adversely impact our business and results of operations.

For example, due to lack of capacity, which resulted in product shortages in early 2010, several major customers in Korea sought alternative suppliers, which impacted our full year revenue in 2011, our year-to-date revenue in 2012 and may continue to impact our revenue in future periods. If we are faced with capacity issues similar to what we experienced in 2010, our product sales and revenue may be further impacted, which could materially and adversely affect our business and results of operations.

We currently depend on three third-party suppliers to provide us with wafers for our products. If any of our wafer suppliers become insolvent or capacity constrained and are unable and/or fail to provide us sufficient wafers at acceptable yields and at anticipated costs, our revenue and gross margin may decline or we may not be able to fulfill our customer orders.

We have a supply arrangement with three suppliers for the production of wafers. Should any of our suppliers become insolvent or capacity constrained, we may not be able to fulfill our customer orders, which would likely cause a decline in our revenue.

While certain aspects of our relationship with these suppliers are contractual, many important aspects of this relationship depend on our suppliers' continued cooperation and our management relationships. In addition, the fabrication of ICs is a highly complex and precise process. Problems in the fabrication process can cause a substantial percentage of wafers to be rejected or numerous ICs on each wafer to be non-functional. This could potentially reduce yields. The failure of our suppliers to supply us wafers at acceptable yields could prevent us from fulfilling our customer orders for our products and would likely cause a decline in our revenue.

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

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

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

There may be unanticipated costs associated with adding to or supplementing our third-party supplier's manufacturing capacity.

We anticipate that future growth of our business will require increased manufacturing capacity on the part of third-party supply foundries, assembly shops, or testing facilities for our products. In order to facilitate such growth, we may need to enter into strategic transactions, investments and other activities. Such activities are subject to a number of risks, including:

§ the costs and expense associated with such activities;

§ the availability of modern foundries to be developed, acquired, leased or otherwise made available to us or our third-party suppliers;

§ the ability of foundries and our third-party suppliers to obtain the advanced equipment used in the production of our products;

§ delays in bringing new foundry operations online to meet increased product demand; and

§ unforeseen environmental, engineering or manufacturing qualification problems relating to existing or new foundry facilities.

These and other risks may affect the ultimate cost and timing of any expansion of our third-party supplier's capacity.

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

As a fabless semiconductor company, we purchase our inventory from a third party manufacturer in advance of selling our product. We place orders with our manufacturer based on existing and expected orders from our customers for particular products. While our contracts with our customers and distributors include lead time requirements and cancellation penalties that are designed to protect us from misalignment between customer orders and inventory levels, we must nonetheless make some predictions when we place orders with our manufacturer. In the event that our predictions are inaccurate due to unexpected increases in orders or unavailability of product within the time frame that is required, we may have insufficient inventory to meet our customer demands. In the event that we order products that we are unable to sell due to a decrease in orders, unexpected order cancellations, injunctions due to patent litigations, or product returns, we may have excess inventory which, if not sold, may need to be disposed of or would result in a decrease in our revenues in future periods as the excess inventory at our distributors is sold. If any of these situations were to arise, it could have a material impact on our business and financial position.

The outcome of currently ongoing and future examinations of our income tax returns by the IRS could have a material adverse effect on our results of operations.

We are subject to examination of our income tax returns by the IRS and other tax authorities. Our U.S. Federal income tax returns for the years ended December 31, 2000 through December 31, 2007 are under examination by the IRS. In April 2011, we received from the IRS a Notice of Proposed Adjustment, or "NOPA", relating to a cost-sharing agreement entered into by the Company and its international subsidiaries on January 1, 2004. In the NOPA, the IRS objected to the Company's allocation of certain litigation expenses between the Company and our international subsidiaries and the amount of "buy-in payments" made by our international subsidiaries to the Company in connection with the cost-sharing agreement, and proposed to increase our U.S. taxable income according to a few alternative methodologies. The methodology resulting in the largest potential adjustment , if the IRS were to prevail on all matters in dispute, would result in potential federal and state income tax liabilities of up to $37.0 million, plus interest and penalties, if any. We believe that the IRS's position in the NOPA is incorrect and that our tax returns for those years were correct as filed. In February 2012, we received a revised NOPA from the IRS (Revised NOPA). In this Revised NOPA, the IRS is raising the same issues as in the NOPA issued in April 2011 but under a different methodology. Under the Revised NOPA, the largest potential adjustment, if the IRS were to prevail on all matters in dispute, has decreased to $10.5 million, plus interest and penalties, if any. The IRS also audited and proposed adjustments on the research and development credits generated in years 2005 through 2007. On March 20, 2012, we received an examination report from the IRS, commonly referred to as a "30-day letter", formally proposing adjustments to the taxable years 2005, 2006 and 2007. As of June 30, 2012, a formal protest to the IRS proposed adjustments has been filed. There is no expected timeframe for us to receive feedback from the IRS. We regularly assess the likelihood of an adverse outcome resulting from such examinations to determine the adequacy of our provision for income taxes. Based on the technical merits of our tax return filing positions, as of June 30, 2012 we believe that it is more-likely-than-not the tax positions we have taken will be sustained upon the resolution of our audits resulting in no material impact on our consolidated financial position and the results of operations and cash flows. As of June 30, 2012, no other audits were in process in any other material jurisdiction.

Changes in effective tax rates or adverse outcomes resulting from examination of our income tax returns could adversely affect our results.

Our future effective tax rates could be adversely affected by earnings being lower than anticipated in countries where we have lower statutory rates and higher than anticipated in countries where we have higher statutory rates, by changes in the valuation of our deferred tax assets and liabilities, or by changes in tax laws, regulations, accounting principles or interpretations thereof. In addition, we are subject to the continuous examination of our income tax returns by the Internal Revenue Service and other tax authorities. We regularly assess the likelihood of adverse outcomes resulting from these examinations to determine the adequacy of our provision for income taxes. There can be no assurance that the outcomes from these continuous examinations will not have an adverse effect on our operating results and financial condition.

The complexity of calculating our tax provision may result in errors that could result in restatements of our financial statements.

Due to the complexity associated with the calculation of our tax provision, we have hired independent tax advisors to assist us in the calculation. If we or our independent tax advisors fail to resolve or fully understand certain issues that we may have had in the past and issues that may arise in the future, we could be subject to errors, which would result in us having to restate our financial statements. For example, because of the complexity of our tax structure, we have had errors in our financial statements in the calculation of our tax provision that previously resulted in restatements of our prior year financial results. Restatements are generally costly and could adversely impact our results of operations and/or have a negative impact on the trading price of our common stock.

If we are unsuccessful in legal proceedings brought against us or any of our competitors, we could be prevented from selling many of our products and/or be required to pay substantial damages. An unfavorable outcome or an additional award of damages, attorneys' fees or an injunction could cause our revenue to decline significantly and could severely harm our business and operating results.

From time to time we are party to various legal proceedings. If we are not successful in litigation that could be brought against us or our customers, we could be ordered to pay monetary fines and/or damages. If we are found liable for willful patent infringement, damages could be doubled or tripled. We and/or our customers could also be prevented from selling some or all of our products. Moreover, our customers and end-users could decide not to use our products or our products or our customers' accounts payable to us could be seized. Finally, interim developments in these proceedings could increase the volatility in our stock price as the market assesses the impact of such developments on the likelihood that we will or will not ultimately prevail in these proceedings.

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

Historically, we have incurred significant expenses in connection with various legal proceedings that vary with the level of activity in the proceeding. It is difficult for us to forecast our legal expenses for any given quarter, which adversely affects our ability to forecast our expected results of operations in general. We may also be subject to unanticipated legal proceedings, which would result in our incurrence of unexpected legal expenses. If we fail to meet the expectations of securities or industry analysts as a result of unexpected changes in our legal expenses, our stock price could be impacted.

Future legal proceedings may divert our financial and management resources.

The semiconductor industry is characterized by frequent claims of infringement and litigation regarding patent and other intellectual property rights. Patent infringement is an ongoing risk, in part because other companies in our industry could have patent rights that may not be identifiable when we initiate development efforts. Litigation may be necessary to enforce our intellectual property rights, and we may have to defend ourselves against additional infringement claims. Such litigation is very costly. In the event any third party makes a new infringement claim against us or our customers, we could incur additional ongoing legal expenses. In addition, in connection with these legal proceedings, we may be required to post bonds to defend our intellectual property rights in certain countries for an indefinite period of time, until such dispute is resolved. If our legal expenses materially increase or exceed anticipated amounts, our capital resources and financial condition be adversely affected. Further, if we are not successful in any of our intellectual property defenses, our financial condition could be adversely affected and our business could be harmed. In addition, our management team may also be required to devote a great deal of time, effort and energy to these legal proceedings, which could distract management's focus on our operations and adversely affect our business.

We will continue to vigorously defend and enforce our intellectual property rights around the world, especially as it relates to patent litigation.

From time to time, we are faced with having to defend our intellectual property rights throughout the world. Should we become engaged in such proceedings, it could divert management's attention from focusing on and implementing our business strategy. Further, should we not be successful in any of our intellectual property enforcement actions, our revenue may be affected and our business could be harmed.

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

We rely heavily on our proprietary technologies. Our future success and competitive position depend in part upon our ability to obtain and maintain protection of certain proprietary technologies used in our products. We pursue patents for some of our new products and unique technologies, and we also rely on a combination of nondisclosure agreements and other contractual provisions, as well as our employees' commitment to confidentiality and loyalty, to protect our technology, know-how, and processes. Despite the precautions we take, it may be possible for unauthorized third parties to copy aspects of our current or future technology or products or to obtain and use information that we regard as proprietary. We intend to continue to protect our proprietary technology, including through patents. However, there can be no assurance that the steps we take will be adequate to protect our proprietary rights, that our patent applications will lead to issued patents, that others will not develop or patent similar or superior products or technologies, or that our patents will not be challenged, invalidated, or circumvented by others.

Furthermore, the laws of the countries in which our products are or may be developed, manufactured, or sold may not protect our products and intellectual property rights to the same extent as laws in the United States. Our failure to adequately protect our proprietary technologies could harm our business.

Credit rating agencies downgraded the credit rating for U.S. long-term sovereign debt and that of certain Eurozone countries could affect global and domestic financial markets, which may affect our business, financial condition and liquidity.

Credit rating agencies downgraded the credit rating for U.S. long-term sovereign debt and that of certain Eurozone countries could materially affect global and domestic financial markets and economic conditions. Although a downgrade of long-term sovereign credit ratings is not unprecedented, a downgrade of the U.S. credit rating is, and the potential impact is uncertain. Management will continue to monitor the situation and there could be future changes in capital requirements or a rebalancing of investment portfolios in response to management's assessment of the related risk weightings. At this time, however, U.S. treasuries continue to trade in active markets, and the yield curve on U.S. treasuries remains an appropriate basis for determining risk-free rates.

Should there be a deterioration of the global and financial markets as a result of the downgraded credit rating for U.S. long-term sovereign debt, and that of certain Eurozone countries, our business, financial condition and liquidity could be adversely affected.

The market for government-backed student loan auction-rate securities has suffered a decline in liquidity which may impact the liquidity and potential value of our investment portfolio.

The market for government-backed student loan auction-rate securities with interest rates that reset through a Dutch auction every 7 to 35 days, became illiquid in 2008. We experienced our first failed auction in mid-February 2008. At June 30, 2012, the Company's investment portfolio included $11.7 million, net of impairment charges of $0.6 million, in government-backed student loan auction-rate securities. As of that date, $12.3 million, the face value of our auction-rate security investments, have failed to reset through successful auctions and it is unclear as to when these investments will regain their liquidity. The underlying maturity of these auction-rate securities is up to 35 years.

Based on certain assumptions described in Note 8, "Fair Value Measurements", to our condensed consolidated financial statements and the Liquidity and Capital Resources section of "Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations" of this quarterly report on Form 10-Q, we recorded temporary and other-than-temporary impairment charges on these investments. The valuation is subject to fluctuations in the future, which will depend on many factors, including the collateral quality, potential to be called or restructured, underlying final maturity, insurance guaranty, liquidity and market conditions, among others.

Should there be further deterioration in the market for auction-rate securities, the value of our portfolio may decline, which may have an adverse impact on our cash position and our earnings. If the accounting rules for these securities change, there may be an adverse impact on our earnings. It is unlikely that we will be able to liquidate our auction-rate securities in the short term.

We face risks in connection with our internal control over financial reporting.

Effective internal controls over financial reporting are necessary for us to provide reliable and accurate financial reports. If we cannot provide reliable financial reports or prevent fraud or other financial misconduct, our business and operating results could be harmed. Our failure to implement and maintain effective internal control over financial reporting could result in a material misstatement of our financial statements or otherwise cause us to fail to meet our financial reporting obligations. This, in turn, could result in a loss of investor confidence in the accuracy and completeness of our financial reports, which could have an adverse effect on our results of operations and/or have a negative impact on the trading price of our common stock, and could subject us to stockholder litigation. For example, because of the complexity of our tax structure, we have had errors in our financial statements in the calculation of our tax provision that previously resulted in restatements of our prior year financial results. Although we believe that we have implemented appropriate internal control over financial reporting related to the computation of our income tax provision, we cannot be certain that any measures we have taken or may take in the future will ensure that we implement and maintain adequate internal control over financial reporting and that we will avoid any material weakness in the future. In addition, we cannot assure you that we will not in the future identify further material weaknesses in our internal control over financial reporting that we have not discovered to date, which may impact the reliability of our financial reporting and financial statements.

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

Our customers generally establish demanding specifications for quality, performance, and reliability that our products must meet. Integrated circuits as complex as ours often encounter development delays and may contain undetected defects or failures when first introduced or after commencement of commercial shipments, which might require product replacement or recall. Further, our third-party manufacturing processes or changes thereof, or raw material used in the manufacturing processes may cause our products to fail. We have from time to time in the past experienced product quality, performance or reliability problems. Our standard warranty period is one year, which exposes the company to significant risks of claims for defects and failures. If defects and failures occur in our products, we could experience lost revenue, increased costs, including warranty expense and costs associated with customer support, delays in, cancellations or rescheduling of orders or shipments, and product returns or discounts, any of which would harm our operating results.

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

The price and availability of commodities (e.g., gold, platinum, copper and silicon) may adversely impact our ability to deliver our products in a timely and cost-effective manner and may affect our business and results of operations.

Our products incorporate commodities such as gold, platinum, copper and silicon. An increase in the price or a decrease in the availability of these commodities and other like commodities that we use could negatively impact our business and results of operations.

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

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

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

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

In addition, the Chinese government and provincial and local governments have provided, and continue to provide, various incentives to encourage the development of the semiconductor industry in China. Such incentives include tax rebates, reduced tax rates, favorable lending policies, and other measures, some or all of which may be available to our manufacturing partners and to us with respect to our facility in China. Any of these incentives could be reduced or eliminated by governmental authorities at any time. Any such reduction or elimination of incentives currently provided to our manufacturing partners could adversely affect our business and operating results.

There are inherent risks associated with the operation of our testing facility in China, which could increase product costs or cause a delay in product shipments.

We have a testing facility in China that began operations in 2006. In addition to the risks discussed elsewhere in this quarterly report on Form 10-Q, we face the following risks, among others, with respect to our testing facility in China:

- inability to hire and maintain a qualified work force;
- inability to maintain appropriate and acceptable manufacturing controls; and
- higher than anticipated overhead and other costs of operation.

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

The average selling prices of products in our markets have historically decreased over time and will likely do so in the future, which could harm our revenues and gross profits.

Average selling prices of semiconductor products in the markets we serve have historically decreased over time. Our gross profits and financial results will suffer if we are unable to offset any reductions in our average selling prices by reducing our costs, developing new or enhanced products on a timely basis with higher selling prices or gross profits, or increasing our sales volumes. Additionally, because we do not operate our own manufacturing or assembly facilities, we may not be able to reduce our costs as rapidly as companies that operate their own facilities, and our costs may even increase, which could also reduce our margins.

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

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

- our customers usually complete an in-depth technical evaluation of our products before they place a purchase order;

- the commercial adoption of our products by OEMs and ODMs is typically limited during the initial release of their product to evaluate product performance and consumer demand;

- our products must be designed into a customer's product or system; and

- the development and commercial introduction of our customers' products incorporating new technologies frequently are delayed.

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

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

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

If we fail to retain key employees in sales, applications, finance and legal or to make continued improvements to our internal systems, particularly in the accounting and finance area, our business may suffer.

If we fail to continue to adequately staff our sales, applications, financial and legal staff, maintain or upgrade our business systems and maintain internal controls that meet the demands of our business, our ability to operate effectively will suffer. The operation of our business also depends upon our ability to retain these employees, as these employees hold a significant amount of institutional knowledge about us and our products, and, if they were to terminate their employment, our sales and internal control over financial reporting could be adversely affected.

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

We plan to continue to expand our domestic and foreign operations through internal growth, strategic relationships, and/or acquisitions. We expect that any such expansion will strain our systems and operational and financial controls. In addition, we are likely to incur significantly higher operating costs. To manage our growth effectively, we must continue to improve and expand our systems and controls, as well as hire experienced administrative and financial personnel. If we fail to do so, our growth will be limited. If we fail to effectively manage our planned expansion of operations, our business and operating results may be harmed.

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

As a part of our business strategy, from time to time we review acquisition prospects that would complement our current product offerings, enhance our design capability or offer other competitive opportunities. In the event of future acquisitions, we could use a significant portion of our available cash, cash equivalents and short-term investments, issue equity securities which would dilute current stockholders' percentage ownership, incur substantial debt or contingent liabilities, and/or incur impairment charges related to goodwill or other intangibles. Such actions by us could impact our operating results and/or the price of our common stock.

In addition, we may be unable to identify or complete prospective acquisition for various reasons, including competition from other companies in the semiconductor industry, the valuation expectations of acquisition candidates and applicable antitrust laws or related regulations. If we are unable to identify and complete acquisitions, we may not be able to successfully expand our business and product offerings.

To the extent we are successful in completing strategic acquisitions, if we are unsuccessful in integrating any acquired company into our operations or if integration is more difficult than anticipated, we may experience disruptions that could harm our business and not realize the anticipated benefits of the acquisitions. Some of the risks that may adversely affect our ability to integrate or realize any anticipated benefits from the acquired companies, businesses or assets include those associated with:

- unexpected losses of key employees or customers of the acquired companies or businesses;
- conforming the acquired company's standards, processes, procedures and controls with our operations;
- coordinating new product and process development;
- hiring additional management and other critical personnel;
- increasing the scope, geographic diversity and complexity of our operations;
- difficulties in consolidating facilities and transferring processes and know-how;
- other difficulties in the assimilation of acquired operations, technologies or products;
- diversion of management's attention from other business concerns; and
- adverse effects on existing business relationships with customers.

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

The analog and mixed-signal semiconductor industry is highly competitive, and we expect competitive pressures to continue. Our ability to compete effectively and to expand our business will depend on our ability to continue to recruit applications and design talent, our ability to introduce new products, and our ability to maintain the rate at which we introduce these new products. We compete with domestic and non-domestic semiconductor companies, many of which have substantially greater financial and other resources with which to pursue engineering, manufacturing, marketing, and distribution of their products. We are in direct and active competition, with respect to one or more of our product lines, with at least 10 manufacturers of such products, of varying size and financial strength. The number of our competitors has grown due to the expansion of the market segments in which we participate. We consider our competitors to include, but not be limited to: Fairchild Semiconductor, Intersil, Linear, Maxim Integrated Products, Micrel, Microsemi, National Semiconductor, O2Micro, RichTek, Rohm, Semtech, STMicroelectronic, Texas Instruments and Volterra. We expect continued competition from existing competitors as well as competition from new entrants in the semiconductor market.

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

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

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

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

Executive officers, directors, and affiliated entities beneficially owned in aggregate, approximately 17% of our outstanding common stock as of June 30, 2012. These stockholders, if acting together, would be able to significantly influence all matters requiring approval by our stockholders, including the election of directors and the approval of mergers or other business combination transactions.

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

Our corporate headquarters, the production facilities of our third-party wafer supplier, our IC testing facility, a portion of our assembly and research and development activities, and certain other critical business operations are located in or near seismically active regions and are subject to periodic earthquakes. We do not maintain earthquake insurance and could be materially and adversely affected in the event of a major earthquake. Much of our revenue, as well as our manufacturers and assemblers, are concentrated in Asia. Such concentration increases the risk that other natural disasters, labor strikes, terrorism, war, political unrest, epidemics, and/or health advisories could disrupt our operations. In addition, we rely heavily on our internal information and communications systems and on systems or support services from third parties to manage our operations efficiently and effectively. Any of these are subject to failure due to a natural disaster or other disruption. System-wide or local failures that affect our information processing could have material adverse effects on our business, financial condition, operating results, and cash flows.

Our facilities in Chengdu, China are located in a seismically active area, as evidenced by the May 2008 earthquake that was centered in the Sichuan Province of China. Although there was no damage to our facilities as a result of that earthquake, should there be additional earthquakes in the area, we may incur losses and our business, financial condition and/or operating results may suffer.

We have a sales facility in Japan, which is located in a seismically active area, as evidenced by the March 2011 earthquake that was centered off the coast of Japan's Miyagi Prefecture. While there was no damage to our facilities as a result of the earthquake, our customers may have experienced disruptions in their supply chains that may impact our revenue in future quarters. Additional earthquakes in the region may have a more significant impact longer term, which could affect our results of operations and financial conditions.

ITEM 4. MINE SAFETY DISCLOSURES

Not Applicable

ITEM 6. EXHIBITS

21.1	Subsidiaries of Monolithic Power Systems, Inc.
31.1	Certification of Chief Executive Officer pursuant to Securities Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Chief Financial Officer pursuant to Securities Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1*	Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101.INS**	XBRL Instance
101.SCH**	XBRL Taxonomy Extension Schema
101.CAL**	XBRL Taxonomy Extension Calculation
101.DEF**	XBRL Taxonomy Extension Definition
101.LAB**	XBRL Taxonomy Extension Labels
101.PRE**	XBRL Taxonomy Extension Presentation

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

** XBRL information is furnished and not filed or a part of a registration statement or prospectus for purposes of sections 11 or 12 of the Securities Act of 1933, as amended, is deemed not filed for purposes of section 18 of the Securities Exchange Act of 1934, as amended, and otherwise is not subject to liability under these sections.

(1) Incorporated by reference to Exhibit 3.2 of the Registrant’s Form S-1 Registration Statement (Registration No. 333-117327), declared effective by the Securities and Exchange Commission on November 18, 2004.
(2) Incorporated by reference to Exhibit 3.4 of the Registrant’s Form S-1 Registration Statement (Registration No. 333-117327), declared effective by the Securities and Exchange Commission on November 18, 2004.

MONOLITHIC POWER SYSTEMS, INC

SIGNATURE

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

MONOLITHIC POWER SYSTEMS, INC.

Dated: July 30, 2012

/s/ MEERA RAO
Meera Rao
Chief Financial Officer
(Principal Financial and Accounting Officer)

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