

MICROTUNE INC  
Form 10-Q  
October 25, 2007  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

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**FORM 10-Q**

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**x** **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
**FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2007**

**OR**

**..** **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
**FOR THE TRANSITION PERIOD FROM \_\_\_\_\_ TO \_\_\_\_\_**

Commission file number 000-31029-40

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**MICROTUNE, INC.**

(Exact name of registrant as specified in its charter)

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**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

**2201 10th Street**

**Plano, Texas 75074**

**75-2883117**  
(I.R.S. Employer

Identification No.)

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(Address of principal executive office and zip code)

(972) 673-1600

(Registrant's telephone number, including area code)

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Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES  NO

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

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

As of October 19, 2007, there were approximately 53,829,050 shares of the registrant's Common Stock, \$0.001 par value per share outstanding.

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**MICROTUNE, INC.**

**FORM 10-Q**

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**Table of Contents****PART I.****FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****MICROTUNE, INC.****CONSOLIDATED BALANCE SHEETS****(In thousands, except per share data)****(unaudited)**

|   | September 30, | December 31, |
|---|---------------|--------------|
|   | 2007          | 2006         |
| <b>Assets</b>   |               |              |
| Current assets:   |               |              |
| Cash and cash equivalents   | \$ 84,261     | \$ 38,010    |
| Short-term investments  |               | 44,750       |
| Accounts receivable, net  | 11,400        | 6,609        |
| Inventories   | 10,206        | 8,988        |
| Other current assets  | 2,834         | 2,127        |
| Total current assets  | 108,701       | 100,484      |
| Property and equipment, net   | 4,038         | 4,275        |
| Other assets and deferred charges   | 3,061         | 843          |
| Total assets  | \$ 115,800    | \$ 105,602   |
| <b>Liabilities and Stockholders Equity</b>  |               |              |
| Current liabilities:  |               |              |
| Accounts payable  | \$ 5,822      | \$ 4,847     |
| Accrued compensation  | 3,643         | 2,646        |
| Accrued expenses  | 2,102         | 1,731        |
| Deferred revenue  | 77            | 23           |
| Total current liabilities   | 11,644        | 9,247        |
| Other non-current liabilities   | 118           | 87           |
| Commitments and contingencies   |               |              |
| Stockholders equity:  |               |              |
| Preferred stock, \$0.001 par value; Authorized 25,000 shares; Issued and outstanding shares none                          |               |              |
| Common stock, \$0.001 par value; Authorized 150,000 shares; Issued and outstanding shares 53,809 and 53,290, respectively | 54            | 53           |
| Additional paid-in capital  | 460,570       | 454,591      |
| Accumulated other comprehensive loss  | (988)         | (988)        |
| Accumulated deficit   | (355,598)     | (357,388)    |
| Total stockholders equity   | 104,038       | 96,268       |

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|  |            |            |
|--|------------|------------|
| Total liabilities and stockholders' equity | \$ 115,800 | \$ 105,602 |
|--|------------|------------|

See accompanying notes.

**Table of Contents****MICROTUNE, INC.****CONSOLIDATED STATEMENTS OF OPERATIONS****(In thousands, except per share data)****(unaudited)**

|   | <b>Three Months Ended</b> |             | <b>Nine Months Ended</b>  |             |
|---|---------------------------|-------------|---------------------------|-------------|
|   | <b>September 30, 2007</b> | <b>2006</b> | <b>September 30, 2007</b> | <b>2006</b> |
| Net revenue                                 | \$ 23,813                 | \$ 17,965   | \$ 68,377                 | \$ 52,660   |
| Cost of revenue                             | 11,823                    | 9,071       | 33,755                    | 26,100      |
| Gross margin                                | 11,990                    | 8,894       | 34,622                    | 26,560      |
| Operating expenses:                         |                           |             |                           |             |
| Research and development                    | 5,782                     | 5,172       | 17,451                    | 15,316      |
| Selling, general and administrative         | 6,179                     | 6,331       | 18,838                    | 15,997      |
| Total operating expenses                    | 11,961                    | 11,503      | 36,289                    | 31,313      |
| Income (loss) from operations               | 29                        | (2,609)     | (1,667)                   | (4,753)     |
| Other income (expense):                     |                           |             |                           |             |
| Interest income                             | 1,054                     | 1,117       | 3,282                     | 3,024       |
| Foreign currency gains (losses), net        | 127                       | (38)        | 219                       | 113         |
| Other                                       | 42                        | 4           | 67                        | 31          |
| Income (loss) before income taxes           | 1,252                     | (1,526)     | 1,901                     | (1,585)     |
| Income tax expense                          | 50                        | 3           | 111                       | 162         |
| Net income (loss)                           | \$ 1,202                  | \$ (1,529)  | \$ 1,790                  | \$ (1,747)  |
| Net income (loss) per common share:         |                           |             |                           |             |
| Basic                                       | \$ 0.02                   | \$ (0.03)   | \$ 0.03                   | \$ (0.03)   |
| Diluted                                     | \$ 0.02                   | \$ (0.03)   | \$ 0.03                   | \$ (0.03)   |
| Weighted-average common shares outstanding: |                           |             |                           |             |
| Basic                                       | 53,753                    | 53,249      | 53,613                    | 53,055      |
| Diluted                                     | 56,596                    | 53,249      | 55,796                    | 53,055      |

See accompanying notes.

**Table of Contents****MICROTUNE, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS****(In thousands)****(unaudited)**

|  | <b>Nine Months Ended</b> |             |
|--|--------------------------|-------------|
|  | <b>September 30,</b>     |             |
|  | <b>2007</b>              | <b>2006</b> |
| <b>Operating activities:</b>   |                          |             |
| Net income (loss)  | \$ 1,790                 | \$ (1,747)  |
| Adjustments to reconcile net income (loss) to cash provided by (used in) operating activities: |                          |             |
| Depreciation   | 1,100                    | 1,141       |
| Foreign currency gains, net  | (219)                    | (113)       |
| Stock-based compensation   | 4,639                    | 4,584       |
| Loss (gain) on sale of assets  | (16)                     | 3           |
| Changes in operating assets and liabilities:   |                          |             |
| Accounts receivable, net   | (4,791)                  | (1,726)     |
| Inventories  | (1,218)                  | (1,190)     |
| Other assets   | (2,925)                  | (580)       |
| Accounts payable   | 975                      | (1,520)     |
| Accrued expenses   | 371                      | 488         |
| Accrued compensation   | 997                      | 496         |
| Deferred revenue   | 54                       | 54          |
| Other liabilities  | 31                       | 3           |
| Net cash provided by (used in) operating activities  | 788                      | (107)       |
| <b>Investing activities:</b>   |                          |             |
| Purchases of property and equipment  | (847)                    | (961)       |
| Proceeds from sale of assets   |                          | 7           |
| Proceeds from maturity of held-to-maturity investments   |                          | 1,620       |
| Proceeds from sale of available-for-sale investments   | 58,750                   | 47,600      |
| Purchase of available-for-sale investments   | (14,000)                 | (34,850)    |
| Net cash provided by investing activities  | 43,903                   | 13,416      |
| <b>Financing activities:</b>   |                          |             |
| Proceeds from issuance of common stock   | 1,341                    | 1,112       |
| Net cash provided by financing activities  | 1,341                    | 1,112       |
| Effect of foreign currency exchange rate changes on cash                                       | 219                      | 113         |
| Net increase in cash and cash equivalents  | 46,251                   | 14,534      |
| Cash and cash equivalents at beginning of period   | 38,010                   | 5,068       |
| Cash and cash equivalents at end of period   | \$ 84,261                | \$ 19,602   |

See accompanying notes.





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**MICROTUNE, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**September 30, 2007**

**(unaudited)**

**1. Summary of Significant Accounting Policies**

**Description of Business**

Microtune, Inc. began operations in August 1996. We design and market radio frequency (RF) integrated circuits (ICs) and subsystem module solutions for the cable, digital television and automotive electronics markets. Our tuner, amplifier and upconverter products permit the delivery, reception and exchange of broadband video, audio and data using terrestrial (off-air) and/or cable communications systems. Our products enable various consumer electronics, broadband communications and automotive electronics applications or devices, including cable television set-top boxes; high-speed voice and data cable modems; car audio, video and antenna amplifier systems; digital/analog televisions, including high-definition televisions; personal computer television (PC/TV) multimedia products; and mobile (handheld) televisions. We sell our products to original equipment manufacturers (OEMs) and original design manufacturers (ODMs) who sell devices and applications to consumers or service providers within the cable, digital television and automotive electronics markets.

We operate Microtune as a single business unit or reportable operating segment serving our target markets. We record our operating expenses by functional area and account type, but we do not record or analyze our operating expenses by market, product type or product. We attempt to analyze our net revenue by market, but in some cases we sell our products to resellers or distributors, giving us limited ability to determine market composition of our net revenue from these customers. In addition, certain of our OEM customers purchase product from us for applications in multiple end-markets, also limiting our ability to determine our net revenue contribution from each market.

**General**

The accompanying unaudited financial statements as of and for the third quarter and first three quarters of 2007 and 2006 have been prepared by us, pursuant to the rules and regulations of the United States Securities and Exchange Commission (SEC). Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States (GAAP) have been condensed or omitted pursuant to such rules and regulations. These unaudited consolidated financial statements should be read in conjunction with the audited financial statements and the notes thereto included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2006.

In the opinion of management, all adjustments which are of a normal and recurring nature and are necessary for a fair presentation of the financial position, results of operations, and cash flows as of and for the third quarter and first three quarters of 2007 and 2006 have been made. Results of operations for the third quarter and first three quarters of 2007 and 2006 are not necessarily indicative of results of operations to be expected for the entire year or any other period.

**Risk and Uncertainties**

Our future results of operations and financial condition will be impacted by the following factors, among others: dependence on the worldwide cable, digital television and automotive electronics markets characterized by intense competition and rapidly changing technology, on a few significant customers, on third-party manufacturers and subcontractors, on third-party distributors in certain markets, on partners when we go to market with a joint solution, on the successful development and marketing of new products in new and existing markets and on seasonality in the demand for consumer products into which our products are incorporated. Our future results also may be impacted by foreign currency fluctuations as a result of our international operations and foreign currency based revenue, and product warranty liabilities and line down clauses. See Part II, Item 1A. Risk Factors and Part I, Item 3. Quantitative and Qualitative Disclosures About Market Risk below.

**Consolidation**

Our consolidated financial statements include the financial statements of Microtune and its wholly-owned subsidiaries. All intercompany balances and transactions have been eliminated in consolidation.



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We make estimates, judgments and assumptions that affect the amounts reported in the financial statements and the disclosures made in the accompanying notes, including inventory valuation allowances, warranty costs, determining the collectibility of accounts receivable, the valuation of deferred tax assets, contingent liabilities and other amounts. We also use estimates, judgments and assumptions to determine the remaining economic lives and carrying values of property and equipment and other long-lived assets. We believe that the estimates, judgments and assumptions upon which we rely are appropriate and correct, based upon information available to us at the time that they are made. These estimates, judgments and assumptions can affect our reported assets and liabilities as of the date of the financial statements, as well as the reported net revenue and expenses during the periods presented. If there are material differences between these estimates, judgments or assumptions and actual facts, our financial statements will be affected.

**Cash and Cash Equivalents**

We consider highly liquid investments with maturities of three months or less at date of purchase to be cash equivalents. Cash and cash equivalents consist of bank deposits and money market funds.

**Investments**

Our investments are comprised of high-quality securities purchased in accordance with our investment policy. Investments in debt securities are classified as held-to-maturity when we intend to hold them to maturity. Held-to-maturity investments are carried at amortized cost with the amortization of the purchase discount recorded in interest income. Investments in debt securities not classified as held-to-maturity and equity securities are classified as available-for-sale and carried at fair market value, with unrealized gains and losses, net of tax, recorded in stockholders' equity. Realized gains and losses and other-than-temporary declines in value, if any, on available-for-sale securities are reported in other income and expense as incurred and are determined based on the specific identification method. At September 30, 2007, we held no short-term investments. At December 31, 2006, our short-term investments, which included corporate debt securities and other debt securities issued by United States government and state agencies, consisted of auction-rate securities categorized as available-for-sale investments. The auction-rate securities in established markets were available to support current operations and were classified as short-term investments although their contractual maturities were greater than 10 years. At September 30, 2007 and December 31, 2006, we held no long-term investments. At December 31, 2006, the carrying value of our investments approximated the fair value. Unrealized gains and losses on our investments categorized as available-for-sale investments were insignificant at December 31, 2006. Our investments are reviewed periodically for other-than-temporary impairment.

**Allowance for Doubtful Accounts**

We evaluate the collectibility of our accounts receivable based on several factors. In circumstances where we are aware of a specific customer's inability to meet its financial obligations to us, we record a specific allowance for bad debts against amounts due to us and reduce the net recorded receivable to the amount we reasonably believe will be collected. We also consider recognizing allowances for doubtful accounts based on the length of time the receivables are outstanding compared to contractual terms, industry and geographic concentrations, the current business environment and our historical experience. Accounts receivable included in the allowance for doubtful accounts are written-off after final collection efforts are exhausted. If the financial condition of our customers deteriorates or if economic conditions worsen, increases in the allowance may be required in the future. We cannot predict future changes in the financial stability of our customers, and there can be no assurance that our allowance will be adequate. Actual credit losses for the third quarter and first three quarters of 2007 and 2006 were insignificant. No allowance for doubtful accounts was recorded as of September 30, 2007 and December 31, 2006.

**Inventory Valuation**

Our inventories are stated at the lower of standard cost, which approximates actual cost, or estimated realizable value. Amounts are removed from inventory using the first-in, first-out (FIFO) method. Adjustments to reduce our inventories to estimated realizable value, including allowances for excess and obsolete inventories, are determined quarterly by comparing inventory levels of individual materials and parts to current demand forecasts for those items. In addition, we review other individual facts and circumstances to determine necessary adjustments to reduce our inventories to estimated realizable value, including current manufacturing yields, product returns and warranty claims. Actual amounts realized upon the sale of inventories may differ from estimates used to determine inventory valuation allowances due to changes in customer demand, technology changes and other factors. The net impact of changes in the inventory valuation allowances for the third quarter of 2007 and 2006 was a charge to cost of revenue of approximately \$0.1 million and \$0.4 million, respectively. The net impact of changes in the inventory valuation allowances for the first three quarters of 2007 was a charge to cost of revenue of approximately \$0.4 million. The net impact of changes in the inventory valuation allowances for the first three quarters of 2006 was insignificant.



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### **Property and Equipment**

Our property and equipment are stated at cost, net of accumulated depreciation. We calculate depreciation using the straight-line method over the estimated useful lives of the assets, which generally range from 3 to 7 years. We depreciate leasehold improvements using the straight-line method over the lesser of their estimated useful lives or remaining lease terms.

### **Impairment of Long-lived Assets**

We review long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of these assets may not be recoverable. We evaluate the recoverability of these assets by a comparison of their carrying amount to projected undiscounted cash flows expected to be generated by the assets or business center. If we determine our long-lived assets are impaired, we recognize the impairment in the amount by which the carrying amount of the assets exceeds the estimated fair value of the assets.

### **Revenue Recognition**

We recognize revenue when we receive a purchase order from our customer, our product has been shipped, title has transferred to our customer, the price that we will receive for our product is fixed or determinable and collection from our customer is considered probable. Title to our product transfers to our customer either when it is shipped to or received by our customer, based on the terms of the customer's specific agreement.

Our revenue is recorded based on the facts then currently known to us. If we do not meet all the criteria above, we do not recognize revenue. If we are unable to determine the amount that we will ultimately collect once our product has shipped and title has transferred to our customer, we defer recognition of revenue until we can determine the amount that ultimately will be collected. Items that are considered when determining the amounts we will ultimately collect are: a customer's overall creditworthiness and payment history, customer rights to return unsold product, customer rights to price protection, customer payment terms conditioned on sale or use of product by the customer, or other extended payment terms granted to a customer. It is not our standard business practice to grant any of these terms to our customers, other than certain limited stock rotation rights discussed below.

For certain of our customers, we do not recognize revenue until receipt of payment because collection is not probable or the amount we will ultimately collect is not determinable at the date of the shipment. Upon shipment of product to these customers, title to the inventory transfers to the customer and the customer is invoiced. We account for these transactions by recording accounts receivable for the revenue value of the shipments, as the shipments represent valid receivables, and reducing inventory for the cost of the inventory shipped. The difference, representing the gross margin on the transactions, is recorded as deferred revenue. For financial statement presentation purposes, this deferred revenue balance is offset against the corresponding accounts receivable balance from the customer. When payment is received for the transaction, revenue is recognized for the value of the cash payment, cost of revenue is recorded for the cost of the inventory and the deferred revenue is relieved for the gross margin on the transaction. At September 30, 2007, there were no products shipped for which revenue was deferred. At December 31, 2006, the sales value of products shipped for which revenue was deferred was approximately \$0.1 million. All of the revenue deferred at December 31, 2006 was recognized during the first quarter of 2007.

When we defer revenue, the timing and amount of revenue we ultimately recognize is determined upon our receipt of payment, which can result in significant fluctuations in revenue from period to period. In the third quarter of 2007, revenue recognized upon receipt of payment was insignificant. In the third quarter of 2006, we recognized 1% of our net revenue upon receipt of payment. In the first three quarters of 2007 and 2006, we recognized 1% and 5%, respectively, of our net revenue upon receipt of payment.

We also defer revenue when customers have made payments and we have not completed the earnings process. These payments are reflected as liabilities in our financial statements as deferred revenue. In these instances, we recognize revenue once the product is shipped, title has transferred to our customer and the earnings process is complete. Deferred revenue as a result of customer prepayments was insignificant as of September 30, 2007 and December 31, 2006.

We grant limited stock rotation rights to certain distributors, allowing them to return qualifying product to us in accordance with their specific agreements for up to 5% of their aggregate net purchases for the previous six months. In these circumstances, we require the distributor to submit an offsetting purchase order that is, at a minimum, equivalent to the aggregate dollar amount of the product to be returned. We account for the return as a reduction to revenue and a reduction to



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accounts receivable for the price of the items returned. Correspondingly, cost of revenue is reduced by the cost of returned inventory offset by an increase in inventory. Any returned inventory items are included in gross inventories, are reviewed along with our other inventory items and are recorded at the lower of cost or market. Historically, distributor returns under stock rotation rights have been insignificant. As a result, we do not establish a reserve for potential returns when product is shipped to distributors, rather we subsequently monitor distributor inventory levels and record a reserve for potential returns of estimated unsaleable inventory subject to stock rotation rights. We account for the shipment of replacement product as a sales transaction, which offsets the reduction of revenue discussed above.

### **Research and Development Costs**

Our research and development expenses consist primarily of personnel-related expenses, lab supplies, training and prototype materials. We expense all of our research and development costs in the period incurred as our current process for developing our products is essentially completed concurrently with the establishment of technological feasibility. Research and development efforts currently are focused primarily on the development of our next generation of RF products.

### **Shipping and Handling Costs**

Shipping and handling costs related to product shipments to customers are included in cost of revenue.

### **Warranty Costs**

We generally provide a minimum of a one-year warranty on all products. In certain instances, a warranty beyond one-year is provided to comply with statutory requirements of foreign jurisdictions. We record specific warranty provisions for any identified individual product issues, which have not been significant to date.

### **Foreign Currency Translation**

Our functional currency is the United States Dollar. The impact from the re-measurement of accounts not denominated in United States Dollars is recognized currently in our results of operations as a component of foreign currency gains and losses and results primarily from exchange rate fluctuations between the United States Dollar and the Euro. Net foreign currency gains were \$0.1 million during the third quarter of 2007 and insignificant during the third quarter of 2006. Net foreign currency gains were \$0.2 million and \$0.1 million during the first three quarters of 2007 and 2006, respectively.

### **Income Taxes**

Our income taxes are computed using the asset and liability method of accounting. Under the asset and liability method, a deferred income tax asset or liability is recognized for estimated future tax effects attributable to temporary differences and carryforwards. The measurement of deferred income tax assets is adjusted by a valuation allowance, if necessary, to recognize future income tax benefits only to the extent, based on available evidence, it is more likely than not such benefits will be realized. Our deferred income tax assets were fully reserved at September 30, 2007 and December 31, 2006.

Effective January 1, 2007, we adopted the provisions of FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes - An Interpretation of FASB Statement No. 109*, or FIN 48. FIN 48 provides detailed guidance for the financial statement recognition, measurement and disclosure of uncertain income tax positions recognized in the financial statements in accordance with SFAS No. 109. Income tax positions must meet a more-likely-than-not recognition threshold at the effective date to be recognized upon the adoption of FIN 48 and in subsequent periods. Upon the adoption of FIN 48, we had no unrecognized income tax benefits. During the third quarter and first three quarters of 2007, we recognized no adjustments for uncertain income tax benefits.

We recognize interest and penalties related to uncertain income tax positions in income tax expense. No interest and penalties related to uncertain income tax positions were accrued at September 30, 2007.

The tax years 2003 through 2006 remain open to examination by the major taxing jurisdictions in which we operate. We expect no material changes to unrecognized income tax positions within the next twelve months.

### **Income (Loss) Per Share**

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Basic income (loss) per common share is computed by dividing net income (loss) by the weighted average number of common shares outstanding during each period. Diluted income (loss) per common share is computed by dividing net income (loss) by the weighted average number of common shares outstanding during each period and dilutive common equivalent shares consisting of stock options, restricted stock, restricted stock units and employee stock purchase plan options. All potentially dilutive common equivalent shares were anti-dilutive and were excluded from diluted loss per common share for the third quarter and first three quarters of 2006.



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Our computation of income (loss) per common shares is as follows (in thousands, except per share data):

|  | Three Months Ended |                    | Nine Months Ended  |                    |
|--|--------------------|--------------------|--------------------|--------------------|
|  | September 30, 2007 | September 30, 2006 | September 30, 2007 | September 30, 2006 |
| Net income (loss)  | \$ 1,202           | \$ (1,529)         | \$ 1,790           | \$ (1,747)         |
| Weighted average common shares outstanding                   | 53,753             | 53,249             | 53,613             | 53,055             |
| Weighted average dilutive potential common shares:           |                    |                    |                    |                    |
| Stock options  | 2,762              |                    | 2,162              |                    |
| Restricted stock units                                       | 71                 |                    | 21                 |                    |
| Employee stock purchase plan                                 | 10                 |                    |                    |                    |
| Weighted average common and dilutive potential common shares | 56,596             | 53,249             | 55,796             | 53,055             |
| Basic income (loss) per common share                         | \$ 0.02            | \$ (0.03)          | \$ 0.03            | \$ (0.03)          |
| Diluted income (loss) per common share                       | \$ 0.02            | \$ (0.03)          | \$ 0.03            | \$ (0.03)          |

The following table sets forth anti-dilutive securities and other securities that have been excluded from diluted earnings per share (in thousands):

|   | Three Months Ended |                    | Nine Months Ended  |                    |
|---|--------------------|--------------------|--------------------|--------------------|
|   | September 30, 2007 | September 30, 2006 | September 30, 2007 | September 30, 2006 |
| Stock options                           | 3,307              | 9,674              | 5,743              | 9,674              |
| Restricted stock units                  | 198                | 93                 | 198                | 93                 |
| Employee stock purchase plan            |                    | 81                 | 136                | 71                 |
| Total anti-dilutive securities excluded | 3,505              | 9,848              | 6,077              | 9,838              |

**Stock-Based Compensation**

Effective January 1, 2006, we adopted the fair value recognition provisions of SFAS No. 123 (revised 2004), *Share-Based Payments*, (SFAS No. 123(R)) for all share-based payment awards to employees and directors including stock options, restricted stock units and employee stock purchases related to our employee stock purchase plan. In addition, we have applied the provisions of Staff Accounting Bulletin No. 107 (SAB No. 107), issued by the SEC, in our adoption of SFAS No. 123(R).

We adopted SFAS No. 123(R) using the modified-prospective-transition method. Under this transition method, stock-based compensation expense recognized after the effective date includes: (1) compensation cost for all share-based payments granted prior to, but not yet vested as of January 1, 2006, based on the measurement date fair value estimate in accordance with the original provisions of SFAS No. 123, and (2) compensation cost for all share-based payments granted subsequent to January 1, 2006, based on the measurement date fair value estimate in accordance with the provisions of SFAS No. 123(R). Stock-based compensation expense under SFAS No. 123(R) was \$1.6 million and \$1.7 million for the third quarter of 2007 and 2006, respectively, and \$4.6 million for both the first three quarters of 2007 and 2006, relating to employee and director stock options, restricted stock units and our employee stock purchase plan. See Note 8.

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Stock-based compensation expense recognized each period is based on the greater of the value of the portion of share-based payment awards under the straight-line method or the value of the portion of share-based payment awards that is ultimately expected to vest during the period. SFAS No. 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.

Upon adoption of SFAS No. 123(R), we elected to use the Black-Scholes-Merton option-pricing formula to value share-based payments granted to employees subsequent to January 1, 2006 and elected to attribute the value of stock-based compensation to expense using the straight-line single option method.

On November 10, 2005, the Financial Accounting Standards Board (FASB) issued FASB Staff Position No. FAS 123(R)-3, Transition Election Related to Accounting for Tax Effects of Share-Based Payment Awards, which detailed an alternative transition method for calculating the tax effects of stock-based compensation pursuant to SFAS No. 123(R). This alternative transition method included simplified methods to establish the beginning balance of the additional paid-in capital pool (APIC pool) related to the tax effects of employee stock-based compensation and to determine the subsequent impact on the APIC pool and Consolidated Statement of Cash Flows of the tax effects of employee stock-based compensation awards that are outstanding upon adoption of SFAS No. 123(R). Due to our historical net operating losses, we have not recorded the tax effects of employee stock-based compensation and have no APIC pool.

SFAS No. 123(R) requires the cash flows resulting from the tax benefits resulting from tax deductions in excess of the compensation cost recognized for those options (excess tax benefits) to be classified as financing cash flows. Due to our historical net operating loss position, we have not recorded these excess tax benefits as of September 30, 2007.

## **Comprehensive Income**

SFAS No. 130, *Reporting Comprehensive Income*, establishes standards for reporting and displaying comprehensive income and its components in the consolidated financial statements. Accumulated other comprehensive loss at September 30, 2007 includes foreign currency translation adjustments of \$1.0 million related to changing the functional currency of our German subsidiaries from the German Mark to the United States Dollar in 2000.

## **Risk Concentrations**

Financial instruments that potentially expose Microtune to concentrations of credit risk consist primarily of trade accounts receivable. At September 30, 2007, approximately 63% of our net accounts receivable were due from five of our customers. We periodically evaluate the creditworthiness of our customers' financial condition and generally do not require collateral. We evaluate the collectibility of our accounts receivable based on several factors. In circumstances when we are aware of a specific customer's inability to meet its financial obligations to us, we record a specific reserve for bad debts against amounts due to us and reduce the net recorded receivable to the amount we reasonably believe will be collected. For all other customers, we recognize allowances for doubtful accounts based on the length of time the receivables are outstanding, industry and geographic concentrations, the current business environment and our historical experience. If the financial condition of our customers deteriorates or if economic conditions worsen, additional allowances may be required in the future. Historically, our bad debts have been insignificant and we are not currently aware of any significant uncollectible accounts. During the third quarter and first three quarters of 2007 and 2006, charges to write-off uncollectible accounts were insignificant. As a result, we have not recorded an allowance for doubtful accounts as of September 30, 2007.

We depend on third-party foundries, primarily IBM, Jazz Semiconductor and X-FAB, to manufacture all of our integrated circuit products. We do not have long-term supply agreements with our foundries but obtain integrated circuit products on a purchase order basis. The inability of a third-party foundry to continue manufacturing our integrated circuits would have a material adverse effect on our operations. Our integrated circuit products are primarily manufactured in the United States, South Korea and the Philippines.

We use Ionics EMS, Inc. (Ionics) for nearly all assembly and calibration functions for our subsystem module solutions. We expect to continue to use a single provider for nearly all assembly and calibration functions for our subsystem module solutions. The unanticipated or sudden loss of this single provider would have a material adverse effect on our operations. We are also dependent upon third-parties, some of whom are competitors, for the supply of components used in subsystem module manufacturing. Our failure to obtain components for module manufacturing would significantly impact our ability to ship subsystem modules to customers in a timely manner.

## **Commitments and Contingencies**

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We may be subject to the possibility of loss contingencies for various legal matters. Our discussion of legal matters includes pending litigation and matters in which any party has manifested a present intention to commence litigation related

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to such matters. There can be no assurance that additional contingencies of a legal nature or having legal aspects will not be asserted in the future. Such matters could relate to prior transactions or events or future transactions and events. See Note 7. We regularly evaluate current information available to us to determine whether any provisions for loss should be made. If we ultimately determine that a provision for loss should be made for a legal matter, the provision for loss could have a material and adverse effect on our operating results and financial position.

Our future cash commitments are primarily for long-term facility leases. See Note 7.

**2. Accounts Receivable, net**

Accounts receivable, net consists of the following (in thousands):

|                           | September 30, | December 31, |
|---------------------------|---------------|--------------|
|                           | 2007          | 2006         |
| Gross accounts receivable | \$ 11,400     | \$ 6,692     |
| Deferred revenue          |               | (83)         |
| Accounts receivable, net  | \$ 11,400     | \$ 6,609     |

**3. Inventories**

Inventories consist of the following (in thousands):

|                   | September 30, | December 31, |
|-------------------|---------------|--------------|
|                   | 2007          | 2006         |
| Finished goods    | \$ 6,066      | \$ 5,714     |
| Work-in-process   | 4,090         | 3,260        |
| Raw materials     | 50            | 14           |
| Total inventories | \$ 10,206     | \$ 8,988     |

**4. Accrued Compensation**

Accrued compensation consists of the following (in thousands):

|  | September 30, | December 31, |
|--|---------------|--------------|
|  | 2007          | 2006         |
| Accrued incentive compensation                   | \$ 1,176      | \$ 959       |
| Accrued vacation                                 | 1,001         | 672          |
| Accrued payroll taxes                            | 662           | 516          |
| Contributions to employee stock purchase program | 415           | 499          |
| Other  | 389           |              |
| Total accrued compensation                       | \$ 3,643      | \$ 2,646     |

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At September 30, 2007 and December 31, 2006, the accrued payroll taxes include \$0.5 million and \$0.6 million, respectively, for liabilities identified during the Audit Committee's investigation into our stock option grant practices. At September 30, 2007, accrued incentive compensation relates primarily to the fiscal year 2007 annual incentive compensation program. See Note 8.

We voluntarily contacted the United States Department of Treasury Internal Revenue Service (IRS) regarding the findings of the Audit Committee's investigation into our stock option grant practices with the intent of pursuing a negotiated settlement with the IRS. The IRS is currently conducting an examination of our payroll tax returns for the years 2003 through 2006 and other related matters. We have received requests from the IRS for the production of documents and we are cooperating with the IRS. The outcome of this ongoing examination is uncertain and the final resolution of the tax issues that have been raised as a result of the Audit Committee's investigation and any other issues raised by the ongoing IRS examination may differ materially from the amounts reserved at September 30, 2007.

**Table of Contents****5. Accrued Expenses**

Accrued expenses consist of the following (in thousands):

|   | September 30,   | December 31,    |
|---|-----------------|-----------------|
|   | 2007            | 2006            |
| Accrued non-cancelable inventory purchase obligations | \$ 535          | \$ 540          |
| Other   | 1,567           | 1,191           |
| <b>Total accrued expenses</b>                         | <b>\$ 2,102</b> | <b>\$ 1,731</b> |

The accrued non-cancelable inventory purchase obligations relate to non-cancelable orders to subcontractors for inventories determined to be excess compared to current inventory levels and current demand forecasts. See Note 7. The accrued expenses are expected to be paid during the next twelve months.

**6. Income Taxes**

We have established a valuation allowance to fully reserve our net deferred income tax assets at September 30, 2007 and December 31, 2006 due to the uncertainty of the timing and amount of future taxable income. For United States federal income tax purposes, at December 31, 2006, we had a net operating loss carryforward of approximately \$175.3 million and an unused research and development credit carryforward of approximately \$4.4 million, that will begin to expire in 2012. A change in ownership, as defined in Section 382 of the Internal Revenue Code, may limit utilization of the United States federal net operating loss and research and development credit carryforwards.

In the third quarter and first three quarters of 2007 and 2006, the effective tax rate differed from the 34% statutory corporate tax rate primarily due to permanent differences, mostly foreign currency remeasurement, changes in valuation allowances and lower foreign income tax rates. The expense for income taxes during the third quarter and first three quarters of 2007 and 2006 primarily consisted of foreign income taxes.

Subsequent to the end of the second quarter of 2006, we agreed with the German tax authorities to fully resolve a then ongoing review and examination relating primarily to the transfer of intellectual property from our German subsidiary to our domestic operating company in 2001; certain cross-border, intercompany pricing and accounting issues; and the valuation of certain investments in subsidiaries. In resolving these matters, we agreed to pay a nominal amount of income tax and interest, agreed to a permanent reduction of our loss carryforward for corporate tax purposes of approximately 2.4 million Euros (approximately \$3.2 million as of December 31, 2006) and agreed to a temporary reduction of our loss carryforward for corporate tax purposes of approximately 0.8 million Euros (approximately \$1.1 million as of December 31, 2006). Because of our current loss carryforward position in Germany, we do not believe the permanent reduction in our loss carryforward will impact our income taxes payable until 2010 or later. The temporary reduction in our loss carryforward will be fully recovered by 2015. As our deferred income tax assets are fully reserved, the reductions to our loss carryforward for corporate income tax purposes in Germany will not impact our current operating results. The income tax liabilities were paid in the first quarter of 2007 and differed from the previously recorded provision by an insignificant amount.

**7. Commitments and Contingencies***Lease Commitments*

In April 2005, we extended our operating lease for our corporate headquarters in Plano, Texas an additional 10 years reducing the monthly base rent and providing a leasehold improvement allowance. This lease extension also included a brief rent abatement and escalating rent payments and provided for certain rights of early termination with corresponding penalties. Rent expense is calculated using the straight-line method over the lease term. We lease an administrative, marketing, and research and development facility in Germany under an operating lease with a twenty-two year term, which began in December 1999. We also lease certain other facilities and equipment under operating leases. Future minimum lease payments required under operating leases as of September 30, 2007 were as follows (in thousands):



**Table of Contents****Year Ending December 31,**

|  |                 |
|--|-----------------|
| 2007                                       | \$ 303          |
| 2008                                       | 1,057           |
| 2009                                       | 943             |
| 2010                                       | 903             |
| 2011                                       | 865             |
| Thereafter                                 | 5,766           |
| <b>Total future minimum lease payments</b> | <b>\$ 9,837</b> |

Rent expense for both the third quarter of 2007 and 2006 was \$0.4 million. Rent expense for the first three quarters of 2007 and 2006 was \$1.1 million and \$1.0 million, respectively.

*Purchase Commitments*

As of October 19, 2007, we had approximately \$15.3 million of cancelable and non-cancelable purchase commitments outstanding with our vendors. These commitments were entered into in the normal course of business.

*Other Commitments*

In June 2007, we renewed our license agreement for engineering software used to design our silicon products. The agreement provides licenses to varying amounts of software tools through June 2011 and will be accounted for as an operating lease. Software license and maintenance expenses will be calculated using the ratable method based upon the value of software tools licensed during each period. The licensed software was delivered in July 2007. License and maintenance fees under the agreement totaled \$3.3 million and were paid during the third quarter of 2007.

We are currently subject to "line down" clauses in contracts with certain automotive electronics customers. Such clauses require us to pay financial penalties if our failure to supply product in a timely manner causes the customer to slow down or stop their production. We are also subject to product liability clauses and/or intellectual property indemnification clauses in some of our customer contracts. Such clauses require us to pay financial penalties if we supply defective product, which results in financial damages to the customer, or to indemnify the customer for third-party actions based on the alleged infringement by our products of a third party's intellectual property. As of September 30, 2007, we were unaware of any significant claims by any of our customers.

*Legal Proceedings*

From time to time, we may be involved in routine legal proceedings, as well as demands, claims and threatened litigation that arise in the ordinary course of our business. The ultimate amount of liability, if any, for any claims of any type (either alone or combined) may materially and adversely affect our financial condition, results of operations and liquidity. Moreover, the ultimate outcome of any litigation is uncertain. Any outcome, whether favorable or unfavorable, may materially and adversely affect us due to legal costs and expenses, diversion of management resources and other factors. There can be no assurance that additional contingencies of a legal nature or contingencies having legal aspects will not be asserted against us in the future. Such matters could relate to prior, current or future transactions or events. Except as described below, we are not currently a party to any material litigation.

*Stock Option Investigation and Derivative Litigation*

In June 2006, the Audit Committee of our Board of Directors self-initiated an independent investigation into our stock option grant practices covering the period from the date of our initial public offering on August 4, 2000 through June 2006. As a result of the Audit Committee's investigation, we recorded additional stock-based compensation expense and related tax liabilities for certain stock option grants made during the review period and restated our consolidated financial statements for the years ended December 31, 2005, 2004, and 2003, and the selected consolidated financial data as of and for the years ended December 31, 2005, 2004, 2003, 2002, 2001, 2000 and 1999. For a discussion of the results of the Audit Committee's investigation and a summary of the restatement, see Note 2, "Restatement of Consolidated Financial Statements" to the Notes to Consolidated Financial Statements included in our Annual Report on Form 10-K for the year ended December 31, 2006.

We voluntarily contacted the SEC regarding the Audit Committee's independent investigation into our stock option grant practices, and representatives of the Audit Committee met with the SEC to discuss the findings of the Audit Committee's investigation. We also voluntarily provided documents to the SEC during its informal inquiry.





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On July 6, 2007, we learned that the previously disclosed informal inquiry of the SEC relating to the findings of the Audit Committee's independent investigation had become formal. We will continue to fully cooperate with the SEC regarding this matter.

On January 31, 2007, a purported stockholder derivative lawsuit was filed in the United States District Court for the Eastern District of Texas Sherman Division against current and former officers and directors of Microtune and Microtune, as a nominal defendant, alleging various breaches of fiduciary duties, conspiracy, improper financial reporting, insider trading, violations of the Sarbanes-Oxley Act, violations of Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder, unjust enrichment, gross mismanagement, abuse of control, and waste of corporate assets related to certain prior grants of stock options by the Company. All defendants, including Microtune, filed motions to dismiss the complaint. Briefing on the motions is complete, and we are awaiting a ruling from the court. The court has stayed discovery while the motions to dismiss are pending.

*Initial Public Offering Litigation*

Starting on July 11, 2001, multiple purported securities fraud class action complaints were filed in the United States District Court for the Southern District of New York naming as defendants several investment banking firms that served as underwriters of our initial public offering, and in one instance, naming Microtune and several of our former officers. The complaints were brought purportedly on behalf of all persons who purchased our common stock from August 4, 2000 through December 6, 2000 and are related to *In re Initial Public Offering Securities Litigation* (IPO cases). The consolidated complaint alleges liability under §§ 11 and 15 of the Securities Act of 1933, as amended (1933 Act Claims) and §§ 10(b) and 20(a) of the Securities Exchange Act of 1934, as amended (1934 Act Claims), on the grounds that the registration statement for our initial public offering did not disclose that (1) the underwriters had agreed to allow certain of their customers to purchase shares in the offering in exchange for excess commissions paid to the underwriters, and (2) the underwriters had arranged for certain of their customers to purchase additional shares in the aftermarket at pre-determined prices. Similar allegations have been made in other lawsuits filed in the Southern District of New York challenging over 300 other initial public offerings and secondary offerings conducted in 1998, 1999 and 2000. Those cases were consolidated for pretrial purposes before the Honorable Shira A. Scheindlin. The Court denied the motions to dismiss the claims.

We have accepted a settlement proposal presented to all issuer defendants. Under the settlement, plaintiffs will dismiss and release all claims against the Microtune defendants. The insurance companies collectively responsible for insuring the issuer defendants in all of the IPO cases will guarantee plaintiffs a recovery of \$1 billion, an amount that covers all of the IPO cases. Under this guarantee, the insurers will pay the difference, if any, between \$1 billion and the amount collected by the plaintiffs from the underwriter defendants in all of the IPO cases. The Microtune defendants will not be required to pay any money in the settlement. However, any payment made by the insurers will be charged to the respective insurance policies covering each issuer's case on a *pro rata* basis (that is, the total insurance company payments will be divided by the number of cases that settle). If the *pro rata* charge exceeds the amount of insurance coverage for an issuer, that issuer would be responsible for additional payments. The proposal also provides that the insurers will pay for the company's legal fees going forward. On December 5, 2006, the U.S. Second Circuit Court of Appeals reversed the district court's ruling certifying the consolidated cases as a class action litigation. The issuer defendants' settlement is contingent upon final approval by the district court. It cannot be determined at this time what effect this ruling will have on the settlement.

On December 14, 2006, the district court ordered a stay of all proceedings in all of the lawsuits pending the outcome of plaintiffs' petition to the Second Circuit for rehearing en banc and resolution of the class certification issue. On April 6, 2007, the Second Circuit denied plaintiffs' petition for rehearing, but clarified that the plaintiffs may seek to certify a more limited class in the district court. Accordingly, the stay remains in place and the plaintiffs and issuers have stated that they are prepared to discuss how the settlement might be amended or renegotiated to comply with the Second Circuit decision. There can be no assurance, however, that the settlement will be successfully renegotiated to comply with the Second Circuit's ruling, and, if renegotiated, will be subsequently approved by the courts. If the renegotiation and approval of the settlement fails, we intend to defend the lawsuit vigorously. Because of the inherent uncertainty of litigation, however, we cannot predict its outcome. If, as a result of this dispute, we are required to pay significant monetary damages, our business could be substantially harmed.

**8. Stockholders' Equity***Common Stock*

On March 4, 2002, our Board declared a dividend of one right for each share of our common stock issued and outstanding at the close of business on March 16, 2002. One right also attaches to each share of our common stock issued subsequent to March 16, 2002. The rights become exercisable to purchase one one-thousandth of a share of new Series A Preferred Stock (Series A), at \$115.00 per right, when a person or entity acquires 15 percent or more of our common stock or



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announces a tender offer which could result in such a person or entity owning 15 percent or more of our common stock. Each one one-thousandth of a share of the Series A has terms designed to make it substantially the economic equivalent of one share of our common stock. Prior to a person or entity acquiring 15 percent, the rights can be redeemed for \$0.001 each by action of our Board. Under certain circumstances, if a person or entity acquires 15 percent or more of our common stock, the rights permit our stockholders other than the acquirer to purchase our common stock having a market value of twice the exercise price of the rights, in lieu of the Series A. Alternatively, when the rights become exercisable, the Board may authorize the issuance of one share of our common stock in exchange for each right that is then exercisable. In addition, in the event of certain business combinations, the rights permit the purchase of the common stock of an acquirer at a 50 percent discount. Rights held by the acquirer will become null and void in both cases. The rights expire on March 3, 2012. On September 30, 2007, 53,809,475 rights were outstanding.

*2007 Incentive Compensation Program*

During the first quarter of 2007, our Board of Directors approved an annual incentive compensation program for fiscal year 2007 (2007 Program) covering executive officers and providing for incentive compensation, to the extent any such compensation is earned, to be paid 35% in cash and 65% through the performance vesting of restricted stock units under the 2000 Stock Plan based upon a stock price of \$5.00 per share. An aggregate of 197,600 restricted stock units were awarded under the 2007 Program with a grant date fair value of \$4.43 per share. The 2007 Program also provides for the payment of cash awards to certain employees to the extent any such compensation is earned. The amount of cash to be paid and number of total restricted stock units that ultimately vest and result in the issuance of underlying shares are calculated based on certain scoring factors, as defined in the 2007 Program, including net revenue and adjusted profitability for 2007. Any cash compensation earned will be paid during the first quarter of 2008. The vesting of the restricted stock units will be determined and the issuance of the underlying shares will occur during the first quarter of 2008. Any portion of the restricted stock units that do not vest will immediately be forfeited and returned to the 2000 Stock Plan. During the third quarter and first three quarters of 2007, stock-based compensation expense recognized under the 2007 Program was \$0.2 million and \$0.6 million, respectively. During the third quarter and first three quarters of 2007, we recognized \$0.4 million and \$1.2 million, respectively, relating to cash awards under the 2007 Program.

*Share-Based Awards*

During the second quarter of 2007, we granted our employees approximately 1.8 million stock options with exercise prices from \$4.22 to \$4.73 per share. In addition, we granted certain members of management approximately 273,000 restricted stock units. The restricted stock units and the majority of the stock options were granted in conjunction with our annual review of all employee compensation and generally vest in two tranches in May 2010 and May 2011. The weighted-average grant date fair value of the stock options granted during the second quarter of 2007 was approximately \$2.39 per share using the Black-Scholes-Merton option-pricing formula. The weighted-average grant date fair value of the restricted stock units granted during the second quarter of 2007 was approximately \$4.53 per share. No share-based awards were issued in conjunction with our annual review of all employee compensation in 2006 due to the Audit Committee's investigation into past stock option grant practices.

*Stock-based Compensation*

Effective January 1, 2006, we adopted the fair value recognition provisions of SFAS No. 123(R) for all share-based payment awards to employees and directors including employee stock options, restricted stock units and employee stock purchases related to our employee stock purchase plan. The following table summarizes the allocation of stock-based compensation expense under SFAS No. 123(R) (in thousands):

|   | Three Months Ended |                    | Nine Months Ended  |                    |
|---|--------------------|--------------------|--------------------|--------------------|
|   | September 30, 2007 | September 30, 2006 | September 30, 2007 | September 30, 2006 |
| Cost of revenue   | \$ 11              | \$ 14              | \$ 32              | \$ 39              |
| Research and development  | 654                | 672                | 1,863              | 1,903              |
| Selling, general and administrative                                   | 968                | 976                | 2,744              | 2,632              |
| Total stock-based compensation expense included in operating expenses | \$ 1,622           | \$ 1,648           | \$ 4,607           | \$ 4,535           |
| Total stock-based compensation expense                                | \$ 1,633           | \$ 1,662           | \$ 4,639           | \$ 4,574           |

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At September 30, 2007, the balance of unearned stock-based compensation to be expensed in future periods related to unvested share-based awards, as adjusted for expected forfeitures and excluding the restricted stock units awarded under the

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2007 Program described above, was approximately \$9.7 million. The weighted-average period over which the unearned stock-based compensation is expected to be recognized is approximately 2.6 years. We anticipate that we will grant additional share-based awards to employees in the future, which will increase the stock-based compensation expense by the additional unearned compensation resulting from these grants. The fair value of these grants is not included in the amount above, as the impact of these grants cannot be predicted at this time because it will depend on the number of share-based payments granted. As we currently anticipate that a portion of the restricted stock units will ultimately vest, these awards will continue to impact stock-based compensation expense. In addition, if factors change and we employ different assumptions in the application of SFAS No. 123(R) in future periods, the stock-based compensation expense that we record under SFAS No. 123(R) may differ significantly from what we have recorded in the current period.

**9. Geographic Information and Significant Customers**

Our corporate headquarters and principal design center is located in Plano, Texas. We have other sales offices and design centers in the United States and other worldwide locations. Net income from foreign operations totaled \$1.0 million and \$0.4 million for the third quarter of 2007 and 2006, respectively. Net income from foreign operations totaled \$1.7 million and \$1.3 million for the first three quarters of 2007 and 2006, respectively. Net revenue by geographical area as derived from shipments to customer locations is summarized below (in thousands):

|                          | Three Months Ended |                  | Nine Months Ended |                  |
|--------------------------|--------------------|------------------|-------------------|------------------|
|                          | September 30,      |                  | September 30,     |                  |
|                          | 2007               | 2006             | 2007              | 2006             |
| North America            | \$ 7,635           | \$ 6,234         | \$ 24,668         | \$ 18,300        |
| Europe                   | 5,169              | 2,918            | 14,251            | 8,616            |
| Asia Pacific             | 10,973             | 8,777            | 29,273            | 25,681           |
| Other                    | 36                 | 36               | 185               | 63               |
| <b>Total net revenue</b> | <b>\$ 23,813</b>   | <b>\$ 17,965</b> | <b>\$ 68,377</b>  | <b>\$ 52,660</b> |

Net revenue derived from shipments to customer locations in countries exceeding 10% of total net revenue were as follows:

|                             | Three Months Ended |      | Nine Months Ended |      |
|-----------------------------|--------------------|------|-------------------|------|
|                             | September 30,      |      | September 30,     |      |
|                             | 2007               | 2006 | 2007              | 2006 |
| China (including Hong Kong) | 31%                | 29%  | 29%               | 27%  |
| Mexico                      | 26%                |      |                   |      |
| Germany                     | 10%                | 10%  | 10%               | 10%  |
| United States               |                    | 33%  | 26%               | 33%  |
| Taiwan                      |                    | 10%  |                   | 10%  |

Sales to our significant customers, including sales to their respective manufacturing subcontractors, as a percentage of net revenue were as follows:

|   | Three Months Ended |      | Nine Months Ended |      |
|---|--------------------|------|-------------------|------|
|   | September 30,      |      | September 30,     |      |
|   | 2007               | 2006 | 2007              | 2006 |
| Cisco/Scientific-Atlanta (a Cisco company) <sup>(1) (3)</sup> | 28%                | 25%  | 31%               | 22%  |
| Asustek Computer <sup>(2)</sup>                               | 23%                | 17%  | 21%               | 16%  |
| Ten largest customers <sup>(3)</sup>                          | 83%                | 78%  | 83%               | 76%  |

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- (1) Cisco Systems, Inc. (Cisco) completed its acquisition of Scientific-Atlanta on February 27, 2006. Revenue generated from Cisco, excluding Scientific-Atlanta, in the third quarter and first three quarters of 2006 was insignificant.
- (2) Primarily for the benefit of ARRIS.
- (3) Includes respective manufacturing subcontractors.

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The locations of property and equipment are summarized below (in thousands):

|                              | September 30, | December 31, |
|------------------------------|---------------|--------------|
|                              | 2007          | 2006         |
| North America                | \$ 2,578      | \$ 2,870     |
| Europe                       | 960           | 1,009        |
| Asia Pacific                 | 500           | 396          |
| Total property and equipment | \$ 4,038      | \$ 4,275     |



**Table of Contents****ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS****Caution Regarding Forward-Looking Statements**

All statements included or incorporated by reference in this Quarterly Report on Form 10-Q, other than statements of historical fact, are forward-looking statements. These forward-looking statements are based upon our current expectations, estimates and projections about our business and our industry, and reflect our beliefs and assumptions based upon information available to us as of the date of this report and are therefore subject to change. In some cases, you can identify these statements by words such as if, may, might, will, should, could, would, expects, plans, anticipates, believes, estimates, predicts, potential, continue, and other similar terms. These forward-looking statements but are not limited to, projections and assessments relating to our future financial performance and our anticipated growth, our accounting estimates, assumptions and judgments, the demand for our products, descriptions of our strategies, our product and market development plans, the trends we anticipate in our business and the markets in which we operate, the competitive nature and anticipated growth of those markets, our dependence on a few key customers for a substantial portion of our net revenue, our ability to continue to successfully partner with strategic demodulator partners, our ability to successfully address new markets where competition is intense, our ability to enter into any agreement with the IRS to settle certain issues related to our stock option investigation and our ability to defend pending and future litigation and regulatory proceedings.

We caution readers that the forward-looking statements in this Quarterly Report on Form 10-Q are predictions based on our current expectations about future events. These forward-looking statements are not guarantees of future performance and are subject to risks, uncertainties and assumptions that are difficult to predict. Our actual results, performance or achievements could differ materially and adversely from those expressed or implied by any forward-looking statements as a result of various factors, some of which are described under the caption Part II, Item 1A. Risk Factors below and in our other filings with the SEC. We caution readers not to rely on these forward-looking statements, which reflect management's analysis only as of the date of this Quarterly Report on Form 10-Q. These forward-looking statements speak only as of the date of this Quarterly Report. We undertake no obligation to revise or update any forward-looking statement for any reason, except as otherwise required by law.

NOTE: For a more complete understanding of our financial condition and results of operations, and some of the risks that could affect our future results, see Risk Factors in Item 1A. of Part I to our Annual Report on Form 10-K for the year ended December 31, 2006, together with the changes thereto disclosed under Risk Factors in Item 1A. of Part II of this Quarterly Report on Form 10-Q, which describe some of the important risk factors that may affect our business, results of operations and financial condition. You should carefully consider those risks, in addition to the other information in this report and in our other filings with the SEC, before deciding to make an investment in our stock. You should also read Quantitative and Qualitative Disclosures About Market Risk in Part I, Item 3. below.

You should also read the following discussion and analysis in conjunction with our Unaudited Consolidated Financial Statements and related Notes in Part I, Item 1., Financial Statements above.

**OVERVIEW**

Microtune, Inc. was incorporated in 1996. We design and market radio frequency (RF) integrated circuits (ICs) and subsystem module solutions for the cable, digital television (DTV) and automotive electronics markets. Our tuner, amplifier and upconverter products permit the delivery, reception and exchange of broadband video, audio and data using terrestrial (off-air) and/or cable communications systems. Our products enable or target various consumer electronics, broadband communications and automotive electronics applications or devices, including cable television set-top boxes; high-speed voice and data cable modems; car audio, video and antenna amplifier systems; digital/analog televisions, including high-definition televisions; personal computer television (PC/TV) multimedia products; and mobile (handheld) televisions. We sell our products to original equipment manufacturers (OEMs) and original design manufacturers (ODMs) who sell devices and applications to consumers or service providers within the cable, digital television and automotive electronics markets. We operate Microtune as a single business unit or reportable operating segment serving our target markets. We record our operating expenses by functional area and account type, but we do not record or analyze our operating expenses by market, product type or product. We attempt to analyze our net revenue by market, but in some cases we sell our products to resellers or distributors, giving us limited ability to determine market composition of our net revenue from these customers. In addition, certain of our OEM customers purchase product from us for applications in multiple end-markets, also limiting our ability to determine our net revenue contribution from each market. In these cases, we are not always able to accurately associate revenue with a market.

The cable, digital television and automotive electronics markets are intensely competitive and historically have seen rapid changes in demand. Certain applications, such as PC/TV, within our target markets can be characterized as having short



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product life cycles due to rapid technological changes, which can result in rapidly decreasing average selling prices (which we attempt to address with our product cost reduction efforts) or rapid turnover in design wins. The volatility of demand within our target markets makes it difficult for us to identify and discuss business trends or to predict future results.

Today, our products are marketed principally to OEMs and ODMs in the following markets:

### *Cable*

Products targeted to this market send and/or receive cable broadband signals. These products include tuners used in consumer premise equipment (CPE), including high-speed voice and data cable modems, digital cable set-top boxes, and hybrid analog/digital cable set-top boxes; upconverter modules and chipsets used in headend modulators; and RF amplifiers used to send and receive signals between the cable headend and CPE.

### *Digital Television*

Products targeted to this market receive digital terrestrial signals. These products are designed for use in consumer electronics devices such as mobile (handheld) televisions; integrated digital television (IDTV) sets; digital terrestrial set-top converter boxes; satellite receivers that include one or more terrestrial tuners used to receive local high-definition television broadcasts; VCRs; portable DVD players; digital personal video recorders (DVRs); DVD recorders and PC/TV multimedia products, including both USB and PCI or PCI Express OEM and add-on devices.

### *Automotive Electronics*

This market includes products targeted for mobile automotive and airline environments, including automobile and airline in-flight entertainment systems. Our automotive electronics products range from components for traditional AM/FM radios (including tuners and in-glass antenna amplifiers) to components for emerging entertainment applications, including in-car television, in-flight video, digital radio, including digital audio broadcast, and HD radio .

We monitor and analyze a number of key performance indicators in order to manage our business and evaluate our financial and operating performance. Those indicators include:

*Net Revenue:* Our net revenue is generated principally by sales of our integrated circuits and subsystem module products directly to OEMs and ODMs who sell devices or applications to consumers or service providers within the cable, digital television and automotive electronics markets. The devices or applications that our customers produce include cable television set-top boxes; high-speed voice and data cable modems; car audio, video and antenna amplifier systems; digital/analog televisions, including HDTVs; PC/TV multimedia products; and mobile (handheld) televisions. We also market and sell to third-party manufacturers and to distributors who sell directly to the OEMs and ODMs. The majority of our net revenue is generated through the efforts of our sales organization. However, we generated approximately 9% and 18% of our net revenue from sales made through distributors in the third quarter of 2007 and 2006, respectively. We generated approximately 9% and 20% of our net revenue from sales made through distributors in the first three quarters of 2007 and 2006, respectively. Our net revenue varies based upon economic and market conditions in the semiconductor industry and our target markets; the timing, rescheduling or cancellation of significant customer orders; our ability, as well as the ability of our customers, to manage inventory; seasonality in the demand for consumer products into which our products are incorporated; and large orders placed by our key customers. These factors may cause our quarterly and yearly net revenue to fluctuate significantly, which makes it difficult for us to discuss revenue trends or to predict future results. We expect these fluctuations will continue in the future. We analyze trends in total net revenue and we attempt to analyze total net revenue trends by market, which is limited due to our lack of visibility into customers and/or applications, as described above. We also analyze revenue from key customers, focusing on our ten-percent customers, and aggregate net revenue from our top ten customers.

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*Cost of Revenue and Gross Margin:* Cost of revenue includes the cost of subcontracted materials, IC assembly, final test, factory labor and overhead, shipping of materials, shipping costs to customers, customs expenses, warranty costs, production employee expenses and inventory charges or benefits relating to excess or obsolete inventory. We also report expenses for the depreciation of our test and handling equipment and logistics in cost of revenue. Significant items impacting cost of revenue include our product mix and volumes of product sales; the position of our products in their respective life cycles; the effects of competitive pricing programs; manufacturing costs; fluctuations in direct product costs such as wafer pricing and assembly, packaging and testing costs, and overhead costs; and provisions for excess or obsolete inventory. Stock-based compensation expense recorded in cost of revenue under SFAS No. 123(R) is insignificant, and is expected to continue to be insignificant as we use third-party contract manufacturers to produce the majority of our products enabling us to

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employ a limited number of production employees. Our cost of revenue may increase due to price fluctuations and cyclical demand and we may not be able to pass this increase on to our customers, which makes it difficult for us to determine if cost of revenue and gross margin trends will continue or to predict future results. We analyze absolute gross margin dollars and gross margin percentage. We also analyze the key drivers of gross margin, namely typical selling price trends and the components of cost of revenue. The typical selling price of our tuner ICs ranges generally from approximately \$2 to \$2.50 for volume purchases. The typical selling price of our subsystem module products ranges generally from \$6 to \$25. In 2007, we expect the average selling price of our products to decrease somewhat; however, more significant decreases, should they occur, could have a material adverse effect on our gross margins, financial condition and results of operations.

*Operating Expenses:* Operating expenses are substantially driven by personnel-related expenses, including cash and stock-based compensation expense, lab supplies, training and prototype materials, professional fees and insurance expenses. Beginning January 1, 2006, stock-based compensation expense is recorded in operating expenses in accordance with SFAS No. 123(R) and has resulted in a material charge each period as the majority of our employees are classified in this category. We analyze trends in the absolute dollar value and percentage of net revenue for research and development and selling, general and administrative expenses. We also analyze the underlying expense inputs of significant operating expenses.

*Other Income and Expense:* We analyze the individual components of other income and expense. We also analyze interest income and the rate of return earned on our cash and cash equivalents and short-term investments.

*Liquidity and Cash Flows:* Our cash flows are primarily driven by our cash operating results and sales of short-term investments. The primary source of our liquidity is our cash and cash equivalents and short-term investments. From period to period, we experience fluctuations in various items, including our working capital accounts, capital expenditures and proceeds from the exercise of employee stock options and shares purchased under our employee stock purchase program.

*Balance Sheet:* We view cash and cash equivalents, short-term investments, accounts receivable, days sales outstanding, inventory, inventory turns, and working capital as important indicators of our financial health.

**RESULTS OF OPERATIONS**

The following table shows certain data from our consolidated statements of operations expressed as a percentage of net revenue:

|                                     | Three Months Ended |                    | Nine Months Ended  |                    |
|-------------------------------------|--------------------|--------------------|--------------------|--------------------|
|                                     | September 30, 2007 | September 30, 2006 | September 30, 2007 | September 30, 2006 |
| Net revenue                         | 100%               | 100%               | 100%               | 100%               |
| Cost of revenue                     | 50                 | 50                 | 49                 | 50                 |
| Gross margin                        | 50                 | 50                 | 51                 | 50                 |
| Operating expenses:                 |                    |                    |                    |                    |
| Research and development            | 24                 | 29                 | 26                 | 29                 |
| Selling, general and administrative | 26                 | 35                 | 27                 | 30                 |
| Total operating expenses            | 50                 | 64                 | 53                 | 59                 |
| Income (loss) from operations       |                    | (14)               | (2)                | (9)                |
| Other income (expense)              | 5                  | 6                  | 5                  | 6                  |
| Income (loss) before income taxes   | 5                  | (8)                | 3                  | (3)                |

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Income tax expense

Net income (loss)

5%

(8)%

3%

(3)%

**Table of Contents****COMPARISON OF THE THREE MONTHS AND NINE MONTHS ENDED SEPTEMBER 30, 2007 AND 2006****Net Revenue**

The following table presents net revenue from each of our product types in the third quarter and first three quarters of 2007 as compared to the third quarter and first three quarters of 2006 (in thousands):

|                   | Three Months Ended |           |          |          | Nine Months Ended |           |           |          |
|-------------------|--------------------|-----------|----------|----------|-------------------|-----------|-----------|----------|
|                   | September 30,      |           |          |          | September 30,     |           |           |          |
|                   | 2007               | 2006      | Change   | % Change | 2007              | 2006      | Change    | % Change |
| Silicon           | \$ 18,341          | \$ 13,763 | \$ 4,578 | 33.3%    | \$ 53,330         | \$ 40,595 | \$ 12,735 | 31.4%    |
| Modules           | 5,344              | 4,173     | 1,171    | 28.1     | 14,874            | 11,708    | 3,166     | 27.0     |
| Other             | 128                | 29        | 99       | 341.4    | 173               | 357       | (184)     | (51.5)   |
| Total net revenue | \$ 23,813          | \$ 17,965 | \$ 5,848 | 32.6%    | \$ 68,377         | \$ 52,660 | \$ 15,717 | 29.8%    |

The increase in net revenue in the third quarter of 2007 as compared to the third quarter of 2006 was primarily the result of increased shipments of silicon tuner products for the cable market and to a lesser extent, the digital television market. The increase in net revenue in the first three quarters of 2007 as compared to the first three quarters of 2006 was primarily the result of increased shipments of silicon tuner products for the cable market, partially offset by decreased shipments of silicon tuner products for the digital television market, particularly for mobile television and PC/TV, and silicon amplifier products for the cable market. An increase in shipments of module products for the automotive electronics market also contributed to the increase in net revenue in the third quarter and first three quarters of 2007 as compared to the third quarter and first three quarters of 2006. Silicon tuner unit shipments increased approximately 51% in the third quarter of 2007 from the third quarter of 2006, primarily in the cable and digital television markets. Silicon tuner shipments increased approximately 33% in the first three quarters of 2007 from the first three quarters of 2006, primarily in the cable market, partially offset by decreased shipments of silicon tuner products for the digital television market, particularly for mobile television and PC/TV. Silicon amplifier unit shipments decreased approximately 56% in the third quarter of 2007 from the third quarter of 2006 and approximately 48% in the first three quarters of 2007 from the first three quarters of 2006, primarily in the cable market, due to the integration of its functionality into one of our partner's demodulator products and also certain of our next-generation silicon tuner products. Module unit shipments increased approximately 11% in the third quarter of 2007 from the third quarter of 2006 and were consistent in the first three quarters of 2007 from the first three quarters of 2006. We expect net revenue to grow approximately 30% in 2007 as compared to 2006, primarily driven by growth from the cable market, and to a lesser extent the automotive electronics market.

Sales to our significant customers, including sales to their respective manufacturing subcontractors, as a percentage of net revenue were as follows:

|  | Three Months Ended |      | Nine Months Ended |      |
|--|--------------------|------|-------------------|------|
|  | September 30,      |      | September 30,     |      |
|  | 2007               | 2006 | 2007              | 2006 |
| Cisco/Scientific-Atlanta (a Cisco company) <sup>(1)(3)</sup> | 28%                | 25%  | 31%               | 22%  |
| Asustek Computer <sup>(2)</sup>                              | 23%                | 17%  | 21%               | 16%  |
| Ten largest customers <sup>(3)</sup>                         | 83%                | 78%  | 83%               | 76%  |

<sup>(1)</sup> Cisco Systems, Inc. (Cisco) completed its acquisition of Scientific-Atlanta on February 27, 2006. Revenue generated from Cisco, excluding Scientific-Atlanta, in the third quarter and first three quarters of 2006 was insignificant.

<sup>(2)</sup> Primarily for the benefit of ARRIS.

<sup>(3)</sup> Includes respective manufacturing subcontractors.

In the third quarter of 2007, revenue recognized upon receipt of payment was insignificant. In the third quarter of 2006, we recognized 1% of our net revenue upon receipt of payment. In the first three quarters of 2007 and 2006, we recognized 1% and 5%, respectively, of our net revenue upon receipt of payment.





**Table of Contents****Cost of Revenue and Gross Margin**

The following table presents cost of revenue and gross margin in the third quarter and first three quarters of 2007 as compared to the third quarter and first three quarters of 2006 (in thousands):

|                 | Three Months Ended |          |          |          | Nine Months Ended |           |          |          |
|-----------------|--------------------|----------|----------|----------|-------------------|-----------|----------|----------|
|                 | September 30,      |          |          |          | September 30,     |           |          |          |
|                 | 2007               | 2006     | Change   | % Change | 2007              | 2006      | Change   | % Change |
| Cost of revenue | \$ 11,823          | \$ 9,071 | \$ 2,752 | 30.3%    | \$ 33,755         | \$ 26,100 | \$ 7,655 | 29.3%    |
| Gross margin    | 11,990             | 8,894    | 3,096    | 34.8%    | 34,622            | 26,560    | 8,062    | 30.4%    |
| Gross margin %  | 50.4%              | 49.5%    | 0.9 pts. |          | 50.6%             | 50.4%     | 0.2 pts. |          |

Gross margin increased in the third quarter of 2007 as compared to the third quarter of 2006 primarily due to an approximate \$5.8 million increase in net revenue and to a lesser extent a 0.9 point increase in gross margin percentage. Gross margin percentage in the third quarter of 2007 as compared to the third quarter of 2006 was positively impacted by a change in the product mix of our silicon tuner products for the cable market and to a lesser extent our silicon tuner products for the digital television market. Gross margin percentage in the third quarter of 2007 as compared to the third quarter of 2006 was also positively impacted by changes in the inventory valuation allowance. As a partial offset, gross margin percentage in the third quarter of 2007 as compared to the third quarter of 2006 was negatively impacted by a change in the product mix of our silicon amplifier products for the cable market. We expect our gross margin percentage for the remainder of 2007 to be approximately 50%, consistent with the percentage reported in recent quarters.

Gross margin increased in the first three quarters of 2007 as compared to the first three quarters of 2006 primarily due to an approximate \$15.7 million increase in net revenue. Gross margin percentage in the first three quarters of 2007 as compared to the first three quarters of 2006 was positively impacted by an increase in net revenue from the cable market as a percentage of total net revenue, which generally has a higher gross margin percentage as compared to other markets, and to a lesser extent, a change in the product mix of our silicon tuner products for the cable market and our module products for the automotive electronics market. Gross margin percentage in the first three quarters of 2007 as compared to the first three quarters of 2006 was negatively impacted by a change in the product mix of our silicon tuner products for the digital television market and silicon amplifiers in the cable market and to a lesser extent changes in the inventory valuation allowance.

Our cost of revenue for the third quarter of 2007 and 2006 benefited from the sale of inventory which had been previously identified as excess to expected demand and expensed in prior periods. The total value of these inventories was approximately \$0.2 million and \$0.3 million for the third quarter of 2007 and 2006, respectively. The net impact of changes in the inventory valuation allowances for the third quarter of 2007 and 2006 was a charge to cost of revenue of approximately \$0.1 million and \$0.4 million, respectively. Cost of revenue for the third quarter of 2007 and 2006 included charges of \$0.3 million and \$0.4 million, respectively, for non-cancelable inventory purchase obligations to subcontractors for inventories determined to be excess compared to current inventory levels and current demand forecasts.

Our cost of revenue for the first three quarters of 2007 and 2006 benefited from the sale of inventory which had been previously identified as excess to expected demand and expensed in prior periods. The total value of these inventories was approximately \$0.5 million and \$0.9 million for the first three quarters of 2007 and 2006, respectively. The net impact of changes in the inventory valuation allowances for the first three quarters of 2007 was a charge to cost of revenue of approximately \$0.4 million. The net impact of changes in the inventory valuation allowances for the first three quarters of 2006 was insignificant. Cost of revenue for the first three quarters of 2007 and 2006 included charges of \$0.6 million and \$0.5 million, respectively, for non-cancelable inventory purchase obligations to subcontractors for inventories determined to be excess compared to current inventory levels and current demand forecasts.

**Table of Contents****Operating Expenses**

The following table presents operating expenses for the third quarter and first three quarters of 2007 as compared to the third quarter and first three quarters of 2006 (in thousands):

|                                     | Three Months Ended |                  |               |             | Nine Months Ended |                  |                 |              |
|-------------------------------------|--------------------|------------------|---------------|-------------|-------------------|------------------|-----------------|--------------|
|                                     | September 30,      |                  |               |             | September 30,     |                  |                 |              |
|                                     | 2007               | 2006             | Change        | % Change    | 2007              | 2006             | Change          | % Change     |
| Research and development            | \$ 5,782           | \$ 5,172         | \$ 610        | 11.8%       | \$ 17,451         | \$ 15,316        | \$ 2,135        | 13.9%        |
| Selling, general and administrative | 6,179              | 6,331            | (152)         | (2.4)       | 18,838            | 15,997           | 2,841           | 17.8         |
| <b>Total operating expenses</b>     | <b>\$ 11,961</b>   | <b>\$ 11,503</b> | <b>\$ 458</b> | <b>4.0%</b> | <b>\$ 36,289</b>  | <b>\$ 31,313</b> | <b>\$ 4,976</b> | <b>15.9%</b> |

*Research and Development*

Our research and development expenses consist primarily of personnel-related expenses, lab supplies, training and prototype materials. To date, we have expensed all of our research and development costs in the period incurred as our process for developing our products has been essentially completed concurrently with the establishment of technological feasibility. Research and development efforts currently are focused primarily on development of our next generation of RF products.

The increase in research and development expenses in the third quarter of 2007 as compared to the third quarter of 2006 was primarily the result of an increase in personnel-related expenses resulting from increased average headcount of approximately 8% and to a lesser extent, charges related to the fiscal year 2007 annual incentive compensation program discussed below. Stock-based compensation expense related to research and development was \$0.7 million in both the third quarter of 2007 and 2006.

The increase in research and development expenses in the first three quarters of 2007 as compared to the first three quarters of 2006 was primarily the result of an increase in personnel-related expenses resulting from increased average headcount of approximately 11% and to a lesser extent, charges related to the fiscal year 2007 annual incentive compensation program discussed below, increased license and maintenance expenses for engineering software used to design our products due to the increase in headcount and an unfavorable change in the Euro to United States Dollar exchange rate affecting our Euro-denominated expenses. Stock-based compensation expense related to research and development was approximately \$1.9 million in both the first three quarters of 2007 and 2006.

We expect research and development expenses to grow approximately 14% to 18% in 2007 as compared to 2006, as we intend to increase the number of RF and technical personnel and increase spending on new product development.

We remain committed to significant research and development efforts to extend our technology leadership in the markets in which we operate. Currently, we hold 70 issued United States utility patents and have 36 additional United States patent applications pending. Our issued United States patents begin to expire in 2015. Our patents generally cover various aspects of our RF and analog technologies at the broad architectural, circuit and building-block levels.

*Selling, General and Administrative*

Selling, general and administrative expenses include our personnel-related expenses for administrative, finance, human resources, sales and marketing, information technology and legal departments, and include expenditures related to professional fees for accounting and legal, public relations and financial advisors. These expenses also include promotional and marketing costs, sales commissions and provisions for doubtful accounts.

The decrease in selling, general and administrative expenses in the third quarter of 2007 as compared to the third quarter of 2006 was primarily due to a decrease in professional fees associated with ongoing legal activities related to our Audit Committee's previously completed investigation into our stock option granting practices and the related restatement of certain historical financial statements, partially offset by an increase in personnel-related expenses resulting from increased average headcount of approximately 4% and to a lesser extent, charges related to the fiscal year 2007 annual incentive compensation program discussed below. Stock-based compensation expense related to selling, general and

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administrative expense was \$1.0 million in both the third quarter of 2007 and 2006. The results of the third quarter of 2007 included charges of \$0.7 million in professional fees relating to ongoing legal activities resulting from our Audit Committee's previously completed investigation into our stock option granting practices, including the ongoing investigation of the SEC and the ongoing derivative litigation. See Part II, Item 1. Legal Proceedings below.

The increase in selling, general and administrative expenses in the first three quarters of 2007 as compared to the first three quarters of 2006 was due to an increase in accounting and legal fees, primarily related to the restatement of our

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financial statements filed in January 2007, the ongoing derivative litigation and the investigation of the SEC, and an increase in personnel-related expenses resulting primarily from an increase in compensation incurred in conjunction with our regular annual compensation adjustments and to a lesser extent, charges related to the fiscal year 2007 annual incentive compensation program discussed below. Stock-based compensation expense related to selling, general and administrative expense was \$2.7 million and \$2.6 million in the first three quarters of 2007 and 2006, respectively. The results in the first three quarters of 2007 included charges of \$2.4 million related to professional fees incurred in connection with the restatement of our financial statements filed in January 2007, the related ongoing derivative litigation and the related investigation of the SEC. See Part II, Item 1. Legal Proceedings below.

We expect selling, general and administrative expenses to grow approximately 14% to 18% in 2007 as compared to 2006, excluding any future professional fees related to our ongoing legal proceedings and potential charges in excess of our current reserves to resolve certain tax issues related to the Audit Committee's investigation. We are currently unable to estimate the level of future professional fees related to our ongoing legal proceedings and potential charges in excess of our current reserves to resolve certain tax issues related to the Audit Committee's investigation.

*Other Income and Expense*

Other income and expense consists primarily of interest income from investments, foreign currency gains and losses and other non-operating income and expenses.

The following table presents other income and expense for the third quarter and first three quarters of 2007 and 2006 (in thousands):

|                                      | Three Months Ended |          |         |          | Nine Months Ended |          |        |          |
|--------------------------------------|--------------------|----------|---------|----------|-------------------|----------|--------|----------|
|                                      | September 30,      |          |         |          | September 30,     |          |        |          |
|                                      | 2007               | 2006     | Change  | % Change | 2007              | 2006     | Change | % Change |
| Interest income                      | \$ 1,054           | \$ 1,117 | \$ (63) | (5.6)%   | \$ 3,282          | \$ 3,024 | \$ 258 | 8.5%     |
| Foreign currency gains (losses), net | 127                | (38)     | 165     | 434.2    | 219               | 113      | 106    | 93.8     |
| Other                                | 42                 | 4        | 38      | 950.0    | 67                | 31       | 36     | 116.1    |
| Total other income and expense       | \$ 1,223           | \$ 1,083 | \$ 140  | 12.9%    | \$ 3,568          | \$ 3,168 | \$ 400 | 12.6%    |

The decrease in interest income in the third quarter of 2007 as compared to the third quarter of 2006 was primarily the result of a slightly lower rate of return achieved in the third quarter of 2007 due to a change in the mix of investment types, partially offset by higher average cash and investment balances. The increase in interest income in the first three quarters of 2007 as compared to the first three quarters of 2006 was primarily the result of higher average cash and investment balances and higher average interest rates earned on our investments.

Our functional currency is the United States Dollar. The impact from the re-measurement of accounts not denominated in United States Dollars is recognized currently in our results of operations as a component of foreign currency gains and losses. Foreign currency gains (losses), net, were primarily a result of exchange rate fluctuations between the United States Dollar and the Euro.

*Income Taxes*

The following table presents our expense for income taxes for the third quarter and first three quarters of 2007 and 2006 (in thousands):

|                    | Three Months Ended |        |          |          | Nine Months Ended |         |           |          |
|--------------------|--------------------|--------|----------|----------|-------------------|---------|-----------|----------|
|                    | September 30,      |        |          |          | September 30,     |         |           |          |
|                    | 2007               | 2006   | Change   | % Change | 2007              | 2006    | Change    | % Change |
| Income tax expense | \$ 50              | \$ 3   | \$ 47    | 1,566.7% | \$ 111            | \$ 162  | \$ (51)   | (31.5)%  |
| Effective tax rate | 4.0%               | (0.2)% | 4.2 pts. |          | 5.8%              | (10.2)% | 16.0 pts. |          |

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In the third quarter and first three quarters of 2007 and 2006, the effective tax rate differed from the 34% statutory corporate tax rate primarily due to permanent differences, mostly foreign currency remeasurement, changes in valuation allowances and lower foreign income tax rates. The income tax expense during the third quarter and first three quarters of 2007 and 2006 primarily consisted of foreign income taxes.

Our income taxes are computed using the asset and liability method of accounting. Under the asset and liability method, a deferred income tax asset or liability is recognized for estimated future tax effects attributable to temporary differences and carryforwards. The measurement of deferred income tax assets is adjusted by a valuation allowance, if necessary, to recognize future income tax benefits only to the extent, based on available evidence, it is more likely than not such benefits will be realized. Our deferred income tax assets were fully reserved at September 30, 2007 and December 31, 2006.

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For United States federal income tax purposes, at December 31, 2006, we had a net operating loss carryforward of approximately \$175.3 million and an unused research and development credit carryforward of approximately \$4.4 million, that will begin to expire in 2012. A change in ownership, as defined in Section 382 of the Internal Revenue Code, may limit utilization of the United States federal net operating loss and research and development credit carryforwards.

Subsequent to the end of the second quarter of 2006, we agreed with the German tax authorities to fully resolve a then ongoing review and examination relating primarily to the transfer of intellectual property from our German subsidiary to our domestic operating company in 2001; certain cross-border, intercompany pricing and accounting issues; and the valuation of certain investments in subsidiaries. In resolving these matters, we agreed to pay a nominal amount of income tax and interest, agreed to a permanent reduction of our loss carryforward for corporate tax purposes of approximately 2.4 million Euros (approximately \$3.2 million as of December 31, 2006) and agreed to a temporary reduction of our loss carryforward for corporate tax purposes of approximately 0.8 million Euros (approximately \$1.1 million as of December 31, 2006). Because of our current loss carryforward position in Germany, we do not believe the permanent reduction in our loss carryforward will impact our income taxes payable until 2010 or later. The temporary reduction in our loss carryforward will be fully recovered by 2015. As our deferred income tax assets are fully reserved, the reductions to our loss carryforward for corporate income tax purposes in Germany will not impact our current operating results. The income tax liabilities were paid in the first quarter of 2007 and differed from the previously recorded provision by an insignificant amount.

**Stock-Based Compensation**

Effective January 1, 2006, we adopted the fair value recognition provisions of SFAS No. 123(R) for all share-based payment awards to employees and directors including employee stock options, restricted stock units and employee stock purchases related to our employee stock purchase plan. The following table summarizes the allocation of stock-based compensation expense under SFAS No. 123(R) (in thousands):

|   | Three Months Ended |                    | Nine Months Ended  |                    |
|---|--------------------|--------------------|--------------------|--------------------|
|   | September 30, 2007 | September 30, 2006 | September 30, 2007 | September 30, 2006 |
| Cost of revenue   | \$ 11              | \$ 14              | \$ 32              | \$ 39              |
| Research and development  | 654                | 672                | 1,863              | 1,903              |
| Selling, general and administrative                                   | 968                | 976                | 2,744              | 2,632              |
| Total stock-based compensation expense included in operating expenses | \$ 1,622           | \$ 1,648           | \$ 4,607           | \$ 4,535           |
| Total stock-based compensation expense                                | \$ 1,633           | \$ 1,662           | \$ 4,639           | \$ 4,574           |

**Net Income (Loss)**

The following table presents our net income (loss) for the third quarter and first three quarters of 2007 and 2006 (in thousands):

|                        | Three Months Ended |                    |           |          | Nine Months Ended |                    |          |          |
|------------------------|--------------------|--------------------|-----------|----------|-------------------|--------------------|----------|----------|
|                        | 2007               | September 30, 2006 | Change    | % Change | 2007              | September 30, 2006 | Change   | % Change |
| Net income (loss)      | \$ 1,202           | \$ (1,529)         | \$ 2,731  | 178.6%   | \$ 1,790          | \$ (1,747)         | \$ 3,537 | 202.5%   |
| Percent of net revenue | 5.0%               | (8.5)%             | 13.5 pts. |          | 2.6%              | (3.3)%             | 5.9 pts. |          |

The increase in net income in the third quarter of 2007 as compared to the third quarter of 2006 was primarily the result of an increase in net revenue, which resulted in an increase of \$3.1 million in gross margin, partially offset by an increase in operating expenses, as described above.

The increase in net income in the first three quarters of 2007 as compared to the first three quarters of 2006 was primarily the result of an increase in net revenue, which resulted in an increase of \$8.1 million in gross margin, and an increase in interest income, partially offset by an increase in operating expenses, as described above.

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Since inception, we have incurred significant losses resulting in an accumulated deficit of approximately \$355.6 million as of September 30, 2007. Our operating history and our business risks, including those risks set forth under the caption *Quantitative and Qualitative Disclosures About Market Risk*, in Part I, Item 3., and under the caption *Risk Factors* in

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Item 1A. of Part I to our Annual Report on Form 10-K for the year ended December 31, 2006, together with the changes thereto disclosed under Risk Factors in Item 1A. of Part II of this Quarterly Report on Form 10-Q, make the prediction of future results of operations difficult. As a result, we cannot assure you that we will sustain revenue growth or profitability.

We have invested heavily in research and development of our RF integrated circuits and subsystem module technology. We expect to continue our investment in these areas to further develop our RF products. This investment may include the continued recruitment of RF and analog integrated circuit designers and systems engineers, and the acquisition of test and development equipment and software development tools for the expansion of our product portfolio. As a result, we may incur substantial losses from operations in the foreseeable future. Furthermore, there can be no assurance that our research and development efforts will result in the timely development and commercial release of products that achieve market acceptance.

The time lag between product availability and volume shipment can be significant due to the sales process for our products, including customer qualification of our products. This delay can be from six months to as long as four years, during which we continue to develop our technology. Due to this lengthy product cycle, we may experience significant delays from the time we incur expenses for research and development, selling, general and administrative efforts, and investments in inventory, to the time we generate corresponding revenue. The rate of new orders may vary significantly from month to month and quarter to quarter. If anticipated sales or shipments in any quarter do not occur when expected, expenses and inventory levels could be disproportionately high, and our results of operations for that quarter, and potentially future quarters, would be materially and adversely affected.

**Liquidity and Capital Resources**

The following tables present key components of our liquidity and capital resources for the first three quarters of 2007 and 2006 and at September 30, 2007 and December 31, 2006, respectively (in thousands):

|   | Nine Months Ended                 |             |                         |                 |
|---|-----------------------------------|-------------|-------------------------|-----------------|
|   | 2007                              | 2006        | September 30,<br>Change | % Change        |
| Operating cash flows                          | \$ 788                            | \$ (107)    | \$ 895                  | 836.4%          |
| Investing cash flows                          | 43,903                            | 13,416      | 30,487                  | 227.2           |
| Financing cash flows                          | 1,341                             | 1,112       | 229                     | 20.6            |
| Capital expenditures                          | 847                               | 961         | (114)                   | (11.9)          |
| Days sales outstanding in accounts receivable | 45                                | 39          | 6                       | 15.4            |
| Inventory turns                               | 4.4                               | 3.8         | 0.6                     | 15.8            |
|   | <b>September 30, December 31,</b> |             |                         |                 |
|   | <b>2007</b>                       | <b>2006</b> | <b>Change</b>           | <b>% Change</b> |
| Cash and cash equivalents                     | \$ 84,261                         | \$ 38,010   | \$ 46,251               | 121.7%          |
| Short-term investments                        |                                   | 44,750      | (44,750)                | (100.0)         |
| Total   | \$ 84,261                         | \$ 82,760   | \$ 1,501                | 1.8%            |
| Accounts receivable, net                      | \$ 11,400                         | \$ 6,609    | \$ 4,791                | 72.5%           |
| Inventories                                   | 10,206                            | 8,988       | 1,218                   | 13.6            |
| Working capital                               | 97,057                            | 91,237      | 5,820                   | 6.4             |

The increase in cash provided by operating activities resulted primarily from an increase in cash operating results and working capital changes in inventories due to an increase in net revenue and accounts payable due to the timing of cash disbursements, partially offset by working capital changes in accounts receivable due to an increase in net revenue and the timing of cash receipts and working capital changes in other assets due to the payment of approximately \$3.3 million for license and maintenance fees associated with renewing our agreement for engineering software used to design our silicon products. Cash operating results increased in the first three quarters of 2007 as compared to the first three quarters of 2006 due to an increase in net revenue and interest income, partially offset by an increase in operating expenses, as described above.





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In the first three quarters of 2007 and 2006, our primary source of cash provided by investing activities was from the sale of available-for-sale investments, partially offset by the purchase of available-for-sale investments.

In the first three quarters of 2007 and 2006, our primary source of cash provided by financing activities was from the exercise of employee stock options and shares purchased under the 2000 Employee Stock Purchase Plan.

We consider highly liquid investments with original maturities of three months or less at date of purchase to be cash equivalents. We generally consider investments with original maturities greater than three months but less than twelve months to be short-term. In addition, auction-rate securities in established markets, which are available to support current operations, are recorded as short-term due to their availability to support current operations although their contractual maturities are greater than 10 years. We consider other investments with original maturities greater than twelve months to be long-term. Cash and cash equivalents consist of bank deposits and money market funds. At September 30, 2007, we held no short-term investments. At December 31, 2006, our short-term investments, which consisted of corporate debt securities and other debt securities issued by United States government and state agencies, including auction-rate securities, were comprised of high-quality securities purchased in accordance with our investment policy. The carrying value of our investments approximate the fair value. Our investments are reviewed periodically for other-than-temporary impairment. In the aggregate, our cash, cash equivalents and short-term investments increased by approximately \$1.5 million during the first three quarters of 2007 as a result of an increase in cash operating results and changes in working capital. We currently have no long-term debt. See Note 1, Summary of Significant Accounting Policies, to the Notes to Unaudited Consolidated Financial Statements.

We expect our operating expenses in the foreseeable future, particularly research and development expenses, sales and marketing expenses, as well as planned capital expenditures, to increase and these expenses could constitute a material use of our cash resources. As a result, our net cash flows will depend heavily on our level of future sales and ability to manage expenses.

**Future Contractual Commitments***Lease Commitments*

In April 2005, we extended our operating lease for our corporate headquarters in Plano, Texas an additional 10 years reducing the monthly base rent and providing a leasehold improvement allowance. This lease extension also included a brief rent abatement and escalating rent payments and provided for certain rights of early termination with corresponding penalties. Rent expense is calculated using the straight-line method over the lease term. We lease an administrative, marketing, and research and development facility in Germany under an operating lease with a twenty-two year term, which began in December 1999. We also lease certain other facilities and equipment under operating leases. Future minimum lease payments required under operating leases as of September 30, 2007 were as follows (in thousands):

| <b>Year Ending December 31,</b>            |                 |
|--|-----------------|
| 2007                                       | \$ 303          |
| 2008                                       | 1,057           |
| 2009                                       | 943             |
| 2010                                       | 903             |
| 2011                                       | 865             |
| Thereafter                                 | 5,766           |
| <b>Total future minimum lease payments</b> | <b>\$ 9,837</b> |

Rent expense for both the third quarter of 2007 and 2006 was \$0.4 million. Rent expense for the first three quarters of 2007 and 2006 was \$1.1 million and \$1.0 million, respectively.

*Purchase Commitments*

As of October 19, 2007, we had approximately \$15.3 million of cancelable and non-cancelable purchase commitments outstanding with our vendors. These commitments were entered into in the normal course of business.

*Other Commitments*

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In June 2007, we renewed our license agreement for engineering software used to design our silicon products. The agreement provides licenses to varying amounts of software tools through June 2011 and will be accounted for as an operating lease. Software license and maintenance expenses will be calculated using the ratable method based upon the value of software tools licensed during each period. The licensed software was delivered in July 2007. License and maintenance fees under the agreement totaled \$3.3 million and were paid during the third quarter of 2007.

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We are currently subject to line down clauses in contracts with certain automotive electronics customers. Such clauses require us to pay financial penalties if our failure to supply product in a timely manner causes the customer to slow down or stop their production. We are also subject to product liability clauses and/or intellectual property indemnification clauses in some of our customer contracts. Such clauses require us to pay financial penalties if we supply defective product, which results in financial damages to the customer, or to indemnify the customer for third-party actions based on the alleged infringement by our products of a third party's intellectual property. As of September 30, 2007, we were unaware of any significant claims by any of our customers.

See Note 7, Commitments and Contingencies, to the Notes to Unaudited Consolidated Financial Statements.

## **CRITICAL ACCOUNTING POLICIES**

Our discussion and analysis of our financial condition and results of operations were based on our Unaudited Consolidated Financial Statements, which have been prepared in accordance with accounting principles generally accepted in the United States (GAAP). Note 1, Summary of Significant Accounting Policies, to the Notes to Unaudited Consolidated Financial Statements describes the significant accounting policies essential to an understanding of our Unaudited Consolidated Financial Statements. Preparation of our financial statements requires estimates, judgments and assumptions. We believe that the estimates, judgments and assumptions which we have used are appropriate and correct based upon information available to us at the time that they were made. These estimates, judgments and assumptions can affect our reported assets and liabilities as of the date of the financial statements, as well as the reported net revenue and expense during the periods presented. If there are material differences between these estimates, judgments or assumptions and actual facts, our financial statements may be affected.

In many cases, the accounting treatment of a particular transaction is specifically dictated by GAAP and does not require our judgment in its application. There could be areas in which our judgment in selecting among available alternatives would not produce a materially different result, but there could be some areas in which our judgment in selecting among available alternatives would produce a materially different result. See the Notes to Unaudited Consolidated Financial Statements that contain additional information regarding our accounting policies and other disclosures.

We believe the following to be our critical accounting policies. That is, they are both important to the portrayal of our financial condition and results, and they require significant estimates, judgments and assumptions about matters that are inherently uncertain.

### **Revenue Recognition**

We recognize revenue when we receive a purchase order from our customer, our product has been shipped, title has transferred to our customer, the price that we will receive for our product is fixed or determinable and collection from our customer is considered probable. Title to our product transfers to our customer either when it is shipped to or received by our customer, based on the terms of the customer's specific agreement.

Our revenue is recorded based on the facts then currently known to us. If we do not meet all the criteria above, we do not recognize revenue. If we are unable to determine the amount that we will ultimately collect once our product has shipped and title has transferred to our customer, we defer recognition of revenue until we can determine the amount that ultimately will be collected. We apply reasonable judgment in performing the credit assessment of each of our customers. Items that are considered when determining the amounts we will ultimately collect are: a customer's overall creditworthiness and payment history, customer rights to return unsold product, customer rights to price protection, customer payment terms conditioned on sale or use of product by the customer, or other extended payment terms granted to a customer. It is not our standard business practice to grant any of these terms to our customers, other than certain limited stock rotation rights discussed below.

For certain of our customers, we do not recognize revenue until receipt of payment because collection is not probable or the amount we will ultimately collect is not determinable at the date of the shipment. Upon shipment of product to these customers, title to the inventory transfers to the customer and the customer is invoiced. We account for these transactions by recording accounts receivable for the revenue value of the shipments, as the shipments represent valid receivables, and reducing inventory for the cost of the inventory shipped. The difference, representing the gross margin on the transactions, is recorded as deferred revenue. For financial statement presentation purposes, this deferred revenue balance is offset against the corresponding accounts receivable balance from the customer. When payment is received for the transaction, revenue is recognized for the value of the cash payment, cost of revenue is recorded for the cost of the inventory and the deferred revenue is relieved for the gross margin on the transaction. At September 30, 2007, there were no products shipped for which revenue was deferred. At December 31, 2006, the sales value of products shipped for which revenue was deferred was approximately \$0.1 million. All of the revenue deferred at December 31, 2006 was recognized during the first quarter of 2007.



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When we defer revenue, the timing and amount of revenue we ultimately recognize is determined upon our receipt of payment, which can result in significant fluctuations in revenue from period to period. In the third quarter of 2007, revenue recognized upon receipt of payment was insignificant. In the third quarter of 2006, we recognized 1% of our net revenue upon receipt of payment. In the first three quarters of 2007 and 2006, we recognized 1% and 5%, respectively, of our net revenue upon receipt of payment.

We also defer revenue when customers have made payments and we have not completed the earnings process. These payments are reflected as liabilities in our financial statements as deferred revenue. In these instances, we recognize revenue once the product is shipped, title has transferred to our customer and the earnings process is complete. Deferred revenue as a result of customer prepayments was insignificant as of September 30, 2007 and December 31, 2006.

We grant limited stock rotation rights to certain distributors, allowing them to return qualifying product to us in accordance with their specific agreements for up to 5% of their aggregate net purchases for the previous six months. In these circumstances, we require the distributor to submit an offsetting purchase order that is, at a minimum, equivalent to the aggregate dollar amount of the product to be returned. We account for the return as a reduction to revenue and a reduction to accounts receivable for the price of the items returned. Correspondingly, cost of revenue is reduced by the cost of returned inventory offset by an increase in inventory. Any returned inventory items are included in gross inventories, are reviewed along with our other inventory items and are recorded at the lower of cost or market. Historically, distributor returns under stock rotation rights have been insignificant. As a result, we do not establish a reserve for potential returns when product is shipped to distributors, rather we subsequently monitor distributor inventory levels and record a reserve for potential returns of estimated unsaleable inventory subject to stock rotation rights. We account for the shipment of replacement product as a sales transaction, which offsets the reduction of revenue discussed above.

We typically have a significant portion of our quarterly net revenue represented in accounts receivable at the end of each financial quarter, often concentrated in significant balances from a limited number of customers. At September 30, 2007, approximately 63% of our net accounts receivable was due from five of our customers. The potential reduction in net revenue resulting from a hypothetical 10% adverse change in the ability or desire of our customers to pay amounts owed to us at September 30, 2007 resulting in the return of product previously delivered would have been approximately \$1.1 million.

### **Allowance for Doubtful Accounts**

We evaluate the collectibility of our accounts receivable based on several factors, which inherently involve us applying judgment and determining certain estimates. In circumstances where we are aware of a specific customer's inability to meet its financial obligations to us, we record a specific allowance for bad debts against amounts due to us and reduce the net recorded receivable to the amount we reasonably believe will be collected. We also consider recognizing allowances for doubtful accounts based on the length of time the receivables are outstanding compared to contractual terms, industry and geographic concentrations, the current business environment and our historical experience. Accounts receivable included in the allowance for doubtful accounts are written-off after final collection efforts are exhausted. If the financial condition of our customers deteriorates or if economic conditions worsen, increases in the allowance may be required in the future. We cannot predict future changes in the financial stability of our customers, and there can be no assurance that our allowance will be adequate. Actual credit losses for the third quarter and first three quarters of 2007 and 2006 were insignificant. No allowance for doubtful accounts was recorded as of September 30, 2007 and December 31, 2006. The potential charge for bad debts resulting from a hypothetical 10% adverse change in the ability or desire of our customers to pay amounts owed to us at September 30, 2007 would have been approximately \$1.1 million.

### **Inventory Valuation**

Our inventories are stated at the lower of standard cost, which approximates actual cost, or estimated realizable value. Amounts are removed from inventory using the first-in, first-out (FIFO) method. Adjustments to reduce our inventories to estimated realizable value, including allowances for excess and obsolete inventories, are determined quarterly by comparing inventory levels of individual materials and parts to current demand forecasts for those items. Our analysis of current and future demand for our products involves estimates and judgments by us. In addition, we review other individual facts and circumstances to determine necessary adjustments to reduce our inventories to estimated realizable value, including current manufacturing yields, product returns and warranty claims, which may also involve judgments by us. Actual amounts realized upon the sale of inventories may differ from estimates used to determine inventory valuation allowances due to changes in customer demand, technology changes and other factors. The net impact of changes in the inventory valuation allowances for the third quarter of 2007 and 2006 was a charge to cost of revenue of approximately \$0.1 million and \$0.4 million, respectively. The net impact of changes in the inventory valuation allowances for the first three quarters of 2007 was a charge to cost of revenue of approximately \$0.4 million. The net impact of changes in the inventory valuation allowances for the first three quarters of 2006 was insignificant. The potential change in inventory valuation allowances resulting from a hypothetical 10% adverse change in the current demand forecasts for individual materials and parts would have been a charge to cost of revenue of approximately \$0.1 million at September 30, 2007.



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Our income taxes are computed using the asset and liability method of accounting. Under the asset and liability method, a deferred income tax asset or liability is recognized for estimated future tax effects attributable to temporary differences and carryforwards. The measurement of deferred income tax assets is adjusted by a valuation allowance, if necessary, to recognize future income tax benefits only to the extent, based on available evidence, it is more likely than not such benefits will be realized. These analyses often involve applying judgments or estimates. Our deferred income tax assets were fully reserved at September 30, 2007 and December 31, 2006.

We have established a valuation allowance to fully reserve our net deferred income tax assets at September 30, 2007 and December 31, 2006 due to the uncertainty of the timing and amount of future taxable income. For United States federal income tax purposes, at December 31, 2006, we had a net operating loss carryforward of approximately \$175.3 million and an unused research and development credit carryforward of approximately \$4.4 million, that will begin to expire in 2012. If we generate United States taxable income in future periods, reversal of this valuation allowance could have a significant positive impact on net income in the period that it becomes more likely than not that the deferred income tax assets will be utilized. A change in ownership, as defined in Section 382 of the Internal Revenue Code, may limit utilization of the United States federal net operating loss and research and development credit carryforwards.

Effective January 1, 2007, we adopted the provisions of FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes - An Interpretation of FASB Statement No. 109*, or FIN 48. FIN 48 provides detailed guidance for the financial statement recognition, measurement and disclosure of uncertain income tax positions recognized in the financial statements in accordance with SFAS No. 109. Income tax positions must meet a more-likely-than-not recognition threshold at the effective date to be recognized upon the adoption of FIN 48 and in subsequent periods. Upon the adoption of FIN 48, we had no unrecognized income tax benefits. During the third quarter and first three quarters of 2007, we recognized no adjustments for uncertain income tax benefits.

We recognize interest and penalties related to uncertain income tax positions in income tax expense. No interest and penalties related to uncertain income tax positions were accrued at September 30, 2007.

The tax years 2003 through 2006 remain open to examination by the major taxing jurisdictions in which we operate. We expect no material changes to unrecognized income tax positions within the next twelve months.

**Stock-Based Compensation**

Effective January 1, 2006, we adopted the fair value recognition provisions of SFAS No. 123 (revised 2004), *Share-Based Payments*, (SFAS No. 123(R)) for all share-based payment awards to employees and directors including stock options, restricted stock units and employee stock purchases related to our employee stock purchase plan. In addition, we have applied the provisions of Staff Accounting Bulletin No. 107 (SAB No. 107), issued by the SEC, in our adoption of SFAS No. 123(R).

We adopted SFAS No. 123(R) using the modified-prospective-transition method. Under this transition method, stock-based compensation expense recognized after the effective date includes: (1) compensation cost for all share-based payments granted prior to, but not yet vested as of January 1, 2006, based on the measurement date fair value estimate in accordance with the original provisions of SFAS No. 123, and (2) compensation cost for all share-based payments granted subsequent to January 1, 2006, based on the measurement date fair value estimate in accordance with the provisions of SFAS No. 123(R). Stock-based compensation expense under SFAS No. 123(R) was \$1.6 million and \$1.7 million for the third quarter of 2007 and 2006, respectively, and \$4.6 million for both the first three quarters of 2007 and 2006, relating to employee and director stock options, restricted stock units and our employee stock purchase plan. See Note 8, *Stockholders' Equity* to the Notes to Unaudited Consolidated Financial Statements.

Stock-based compensation expense recognized each period is based on the greater of the value of the portion of share-based payment awards under the straight-line method or the value of the portion of share-based payment awards that is ultimately expected to vest during the period. SFAS No. 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.

Upon adoption of SFAS No. 123(R), we elected to use the Black-Scholes-Merton option-pricing formula to value share-based payments granted to employees subsequent to January 1, 2006 and elected to attribute the value of stock-based compensation to expense using the straight-line single option method.





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On November 10, 2005, the Financial Accounting Standards Board (FASB) issued FASB Staff Position No. FAS 123(R)-3, Transition Election Related to Accounting for Tax Effects of Share-Based Payment Awards, which detailed an alternative transition method for calculating the tax effects of stock-based compensation pursuant to SFAS No. 123(R). This alternative transition method included simplified methods to establish the beginning balance of the additional paid-in capital pool (APIC pool) related to the tax effects of employee stock-based compensation and to determine the subsequent impact on the APIC pool and Consolidated Statement of Cash Flows of the tax effects of employee stock-based compensation awards that are outstanding upon adoption of SFAS No. 123(R). Due to our historical net operating losses, we have not recorded the tax effects of employee stock-based compensation and have no APIC pool.

SFAS No. 123(R) requires the cash flows resulting from the tax benefits resulting from tax deductions in excess of the compensation cost recognized for those options (excess tax benefits) to be classified as financing cash flows. Due to our historical net operating loss position, we have not recorded these excess tax benefits as of September 30, 2007.

During the first quarter of 2007, our Board of Directors approved an annual incentive compensation program for fiscal year 2007 (2007 Program) covering executive officers and providing for incentive compensation, to the extent any such compensation is earned, to be paid 35% in cash and 65% through the performance vesting of restricted stock units under the 2000 Stock Plan based upon a stock price of \$5.00 per share. An aggregate of 197,600 restricted stock units were awarded under the 2007 Program with a grant date fair value of \$4.43 per share. The 2007 Program also provides for the payment of cash awards to certain employees to the extent any such compensation is earned. The amount of cash to be paid and number of total restricted stock units that ultimately vest and result in the issuance of underlying shares are calculated based on certain scoring factors, as defined in the 2007 Program, including net revenue and adjusted profitability for 2007. Any cash compensation earned will be paid during the first quarter of 2008. The vesting of the restricted stock units will be determined and the issuance of the underlying shares will occur during the first quarter of 2008. Any portion of the restricted stock units that do not vest will immediately be forfeited and returned to the 2000 Stock Plan. During the third quarter and first three quarters of 2007, stock-based compensation expense recognized under the 2007 Program was \$0.2 million and \$0.6 million, respectively. During the third quarter and first three quarters of 2007, we recognized \$0.4 million and \$1.2 million, respectively, relating to cash awards under the 2007 Program.

At September 30, 2007, the balance of unearned stock-based compensation to be expensed in future periods related to unvested share-based awards, as adjusted for expected forfeitures and excluding the restricted stock units awarded under the 2007 Program described above, was approximately \$9.7 million. The weighted-average period over which the unearned stock-based compensation is expected to be recognized is approximately 2.6 years. We anticipate that we will grant additional share-based awards to employees in the future, which will increase the stock-based compensation expense by the additional unearned compensation resulting from these grants. The fair value of these grants is not included in the amount above, as the impact of these grants cannot be predicted at this time because it will depend on the number of share-based payments granted. As we currently anticipate that a portion of the restricted stock units will ultimately vest, these awards will continue to impact stock-based compensation expense. In addition, if factors change and we employ different assumptions in the application of SFAS No. 123(R) in future periods, the stock-based compensation expense that we record under SFAS No. 123(R) may differ significantly from what we have recorded in the current period.

**Commitments and Contingencies**

We may be subject to the possibility of loss contingencies for various legal matters. Our discussion of legal matters includes pending litigation and matters in which any party has manifested a present intention to commence litigation related to such matters. There can be no assurance that additional contingencies of a legal nature or having legal aspects will not be asserted in the future. Such matters could relate to prior transactions or events or future transactions and events. See Note 7, Commitments and Contingencies, to the Notes to Unaudited Consolidated Financial Statements. We regularly evaluate current information available to us to determine whether any provisions for loss should be made. If we ultimately determine that a provision for loss should be made for a legal matter, the provision for loss could have a material and adverse effect on our operating results and financial condition.

Our future cash commitments are primarily for long-term facility leases. See Note 7, Commitments and Contingencies, to the Notes to Unaudited Consolidated Financial Statements.

**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

There have been no significant changes to the information required under this Item from what was disclosed in our Annual Report on Form 10-K for the fiscal year ended December 31, 2006.



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**ITEM 4. CONTROLS AND PROCEDURES**

*Disclosure Controls and Procedures.* We have evaluated, under the supervision and with the participation of our Chief Executive Officer (CEO) and our Chief Financial Officer (CFO), the effectiveness of our disclosure controls and procedures as of the end of the period covered by this Quarterly Report on Form 10-Q (the Evaluation Date). Based on this evaluation, our CEO and CFO have concluded that, as of the Evaluation Date, our disclosure controls and procedures were effective to ensure that information required to be disclosed by Microtune in the reports we file or submit under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified by the SEC's rules and forms.

*Changes in Internal Control over Financial Reporting.* There has been no change in our internal control over financial reporting that occurred during the quarter ended September 30, 2007 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

**PART II.**

**OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS**

The information set forth under the heading *Legal Proceedings* in Note 7, *Commitments and Contingencies*, to the Notes to Unaudited Consolidated Financial Statements, included in Part I, Item 1. of this Report, is incorporated herein by reference.

**ITEM 1A. RISK FACTORS**

There have been no material changes to the risk factors previously disclosed in our Annual Report on Form 10-K for the fiscal year ended December 31, 2006 (2006 10-K) except as described below. The description of these material changes does not represent a comprehensive list of risk factors that could cause our results to differ from those that are currently anticipated and therefore should be read in conjunction with the risk factors and other information disclosed in our 2006 10-K.

**Market-specific risks affecting the integrated digital television, PC/TV and television peripheral market segments of the digital television market could impair our ability to compete successfully in that market.**

The market for digital television applications in integrated televisions, PC/TVs and television peripherals is characterized by various market-specific risks, any of which may adversely affect our ability to compete in that market.

Examples of market-specific risks affecting these market segments include:

the risk that module tuners that offer the same or similar functionality as our silicon tuner solutions will continue to be used by OEMs and will be viewed as more attractive by our current and potential customers including the use by our potential customers of captive module tuner suppliers due to more favorable economics;

the risk that module tuners that offer the same or similar functionality as our silicon tuner solutions will be sold at lower prices than our silicon tuner solutions;

the risk that the US ATSC PC/TV market will not be as large as anticipated or our share in the market will be lower than anticipated;

the risk that tuner performance requirements for the US ATSC PC/TV market are less stringent and thereby increase the competitive element in this market;

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the risk that the suppliers of module tuners who currently sell tuners to television manufacturers that we are currently targeting with our silicon tuner, may dramatically lower their prices, including to levels below their cost, in order to protect their existing relationships, making our tuner uncompetitive from a customer cost perspective;

the risk that we will be unable to develop silicon tuners that meet the performance requirements of our customers;

risks related to systems integration and other risks, including the timing of open design windows, inherent in the highly complex design-in process of the products designed to address this market;

the risk that we will not be able to finalize the highly complex design-in process for a particular customer application during the narrow customer design window;

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the risk that module products implementing our silicon tuners will not be selected by potential end customers due to the economics of the entire module solution where other components are unattractively priced;

the risk that our products will not have the feature set desired by our customers or will not be architecturally compatible with other components in the customers' designs;

the risk that an influx of entrants into the digital television market due to a faster than expected transition to all digital will accelerate average selling price erosion; and

the risk that multi-standard, poly-band, universal television tuners will be preferred by digital television manufacturers and our multi-standard, poly-band, universal television tuners may not meet performance expectations or be available in the necessary timeframe.

Our efforts to penetrate the digital television market, in particular, will depend on our ability to overcome the challenges described above and upon eventual acceptance of our new digital television products, such as the MT2131. To the extent our efforts are adversely affected by any of these risks or are otherwise unsuccessful, we could experience a material adverse effect on our business prospects, financial condition and results of operations.

### **The market opportunity for coupon eligible converter boxes (CECB) may not be as large as anticipated or we may not realize significant market share in this segment of the digital television market.**

In anticipation of the shut off of analog terrestrial (off-air) television broadcasts in the United States in February 2009, the federal government plans to subsidize the purchase of digital converter boxes by consumers who wish to receive off-air digital television broadcasts and continue to watch television on analog televisions (analog televisions would not have a digital tuner and would not be able to receive digital television broadcast signals). This market is characterized by various market risks described above for the digital television market generally and market specific risks for the CECB market segment described below, any of which may adversely affect our ability to compete in the CECB market segment:

the risk that we may not be able to achieve early, significant market share and given the short duration of the CECB market segment (January 1, 2008 through June 30, 2009), there may not be significant design-in opportunities after the initial tuner component selections to later increase market share;

the risk that the CECB market segment will not be as large as anticipated or will not commence in the near-term as planned;

the risk that the minimum RF performance levels as defined in the A/74 guidelines, required by the federal government for set-top converter box performance to qualify for government subsidies, will be relaxed or eliminated, or will, by virtue of the fact that adherence to the A/74 guidelines is partially self-policing and a function of the performance of other non-tuner parts, be ineffective and thereby allow suppliers with non-compliant tuners to realize significant market share in this segment; and

the risk that our tuner may not be deemed compliant with the A/74 guidelines, which would significantly diminish or eliminate our ability to participate in this opportunity.

**The matters relating to the investigation by the Audit Committee of our Board of Directors into our stock option grant practices and the restatement of our consolidated financial statements has resulted in derivative litigation and a formal investigation by the United States Securities and Exchange Commission and may result in future litigation and governmental inquiries which could harm our financial condition and results of operations.**

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On July 27, 2006, we announced that the Audit Committee of our Board of Directors, with the assistance of independent legal counsel, was conducting a review of our stock option grant practices covering the time from our initial public offering in August 2000 through June 2006.

On November 1, 2006, the Audit Committee announced that it had concluded that the actual measurement dates for certain past stock option grants differed from the measurement dates previously used in accounting for such grants. Because, in certain cases, the prices on the previously used measurement dates were lower than the prices on the actual measurement dates, we determined that we should have recognized material amounts of stock-based compensation expense in connection with these transactions. Therefore, we concluded that our previously filed unaudited interim and audited annual consolidated financial statements for the years ended December 31, 2005, 2004, 2003, 2002 and 2001, as well as the unaudited interim financial statements for the first quarter ended March 31, 2006, should no longer be relied upon because these financial statements contained misstatements and would need to be restated. We disclosed this conclusion in our Current Report on Form 8-K, filed with the SEC on November 1, 2006.

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On January 22, 2007 we filed with the SEC certain restated financial statements for the years ended December 31, 1999, 2000, 2001, 2002, 2003, 2004 and 2005, as well as unaudited interim financial statements for the quarter ended March 31, 2006.

This investigation of our historical stock option grant practices and the resulting derivative litigation and SEC investigation described below have required us to incur substantial expenses for legal, accounting, tax and other professional services, has diverted our management's attention from our business, and could in the future adversely affect our business, financial condition, results of operations and cash flows.

On January 31, 2007, a purported stockholder derivative lawsuit was filed against current and former officers and directors of Microtune and against Microtune, as a nominal defendant, alleging various breaches of fiduciary duties, conspiracy, improper financial reporting, insider trading, violations of the Sarbanes-Oxley Act, violations of Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder, unjust enrichment, gross mismanagement, abuse of control, and waste of corporate assets related to certain prior grants of stock options by the Company. All defendants, including Microtune, have filed motions to dismiss the complaint. Briefing on the motions is complete, and we are awaiting a ruling from the court. The court has stayed discovery while the motions to dismiss are pending.

We voluntarily contacted the SEC in July 2006 regarding the Audit Committee's investigation into our stock option grant practices, and representatives of the Audit Committee met with the SEC in February 2007 to discuss the findings of the Audit Committee's investigation. On July 6, 2007, we learned that the previously disclosed informal inquiry of the SEC relating to the findings of the Audit Committee's independent investigation had become formal. We will continue to cooperate with the SEC in its investigation of these matters.

We cannot assure you that the pending derivative litigation, SEC investigation or any future litigation or governmental action will result in the same conclusions reached by the Audit Committee. While we believe that we have made appropriate judgments in determining the correct measurement dates for stock option grants, the SEC may disagree with our measurement date determinations and also may disagree with the manner in which we have accounted for and reported, or not reported, the financial impact of past stock option grant measurement date errors, and there is a risk that the SEC investigation could lead to circumstances in which we may have to further restate our prior financial statements, amend prior SEC filings, or otherwise take other actions not currently contemplated. Any such circumstance could also lead to future delays in filing our subsequent SEC reports and the delisting of our common stock from The NASDAQ Global Market. Furthermore, if we are subject to adverse findings in any of these matters, we could be required to pay damages or penalties or have other remedies imposed upon us or our current officers and directors which could harm our business, financial condition, results of operations and cash flows. See Note 2, Restatement of Consolidated Financial Statements of the Notes to Consolidated Financial Statements included in our Annual Report on Form 10-K for the year ended December 31, 2006.

**We have been the target of several securities fraud class action and stockholder derivative complaints in the past and continue to be at risk of future securities class action and stockholder derivative litigation. The lawsuit filed on January 31, 2007 or litigation filed in the future could result in substantial costs to us, drain our resources and divert our management's time and attention.**

*Initial Public Offering Litigation*

Starting on July 11, 2001, multiple purported securities fraud class action complaints were filed against us, certain former executive officers and certain investment banks that served as underwriters of our initial public offering. This case was consolidated with over 300 similar cases filed in the Southern District of New York challenging initial public offerings and secondary offerings conducted in 1998, 1999 and 2000. We previously accepted a settlement proposal presented to all issuer defendants. In December 2006, however, the United States Second Circuit Court of Appeals reversed the District Court's certification of the consolidated cases as a class action litigation. The plaintiffs and issuers are now attempting to amend or renegotiate the settlement, but there can be no assurance that the settlement can be successfully renegotiated and, if renegotiated, will be approved by the courts.

*Stockholder Derivative Litigation*

On January 31, 2007, a purported stockholder derivative lawsuit was filed against current and former officers and directors of Microtune and against Microtune, as a nominal defendant, alleging various breaches of fiduciary duties, conspiracy, improper financial reporting, insider trading, violations of the Sarbanes-Oxley Act, violations of Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder, unjust enrichment, gross mismanagement, abuse of control, and



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waste of corporate assets related to certain prior grants of stock options by the Company. All defendants, including Microtune, have filed motions to dismiss the complaint. Briefing on the motions is complete, and we are awaiting a ruling from the court. The court has stayed discovery while the motions to dismiss are pending.

**ITEM 6. EXHIBITS**

**Exhibit**

**Number**

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|--------------------|---|
| 3.1 <sup>(1)</sup> | Restated Certificate of Incorporation filed with the Secretary of State of the State of Delaware on May 25, 2005. |
| 3.2 <sup>(1)</sup> | Third Amended and Restated Bylaws, as amended April 13, 2005.   |
| 31.1               | Certification of Chief Executive Officer under Section 302 of the Sarbanes-Oxley Act of 2002.                     |
| 31.2               | Certification of Chief Financial Officer under Section 302 of the Sarbanes-Oxley Act of 2002.                     |
| 32.1               | Certification of Chief Executive Officer under Section 906 of the Sarbanes-Oxley Act of 2002.                     |
| 32.2               | Certification of Chief Financial Officer under Section 906 of the Sarbanes-Oxley Act of 2002.                     |

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<sup>(1)</sup> Incorporated by reference to the Registrant's Current Report on Form 8-K filed on May 31, 2005.

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**SIGNATURES**

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.

**MICROTUNE, INC.**

By: /s/ JEFFREY A. KUPP  
Jeffrey A. Kupp  
Chief Financial Officer  
(Principal Financial Officer and Principal  
Accounting Officer)

Date: October 25, 2007