

MICROTUNE INC
Form 10-Q
April 28, 2006
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-Q

(Mark one)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2006

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

MICROTUNE, INC.

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of

Incorporation or organization)

2201 10th Street

Plano, Texas 75074

75-2883117
(I.R.S. Employer

Identification Number)

Edgar Filing: MICROTUNE INC - Form 10-Q

(Address of principal executive office and zip code)

(972) 673-1600

(Registrant's telephone number, including area code)

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES 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 April 21, 2006, there were approximately 52,903,599 shares of the Registrant's Common Stock, \$0.001 par value per share outstanding.

Table of Contents

MICROTUNE, INC.

FORM 10-Q

March 31, 2006

INDEX

	Page
<u>Part I. Financial Information</u>	
Item 1. <u>Financial Statements</u>	4
<u>Consolidated Balance Sheets at March 31, 2006 and December 31, 2005 (unaudited)</u>	4
<u>Consolidated Statements of Operations for the Three Months Ended March 31, 2006 and 2005 (unaudited)</u>	5
<u>Consolidated Statements of Cash Flows for the Three Months Ended March 31, 2006 and 2005 (unaudited)</u>	6
<u>Notes to Consolidated Financial Statements (unaudited)</u>	7
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	21
Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	34
Item 4. <u>Controls and Procedures</u>	35
<u>Part II. Other Information</u>	
Item 1. <u>Legal Proceedings</u>	36
Item 1A. <u>Risk Factors</u>	36
Item 6. <u>Exhibits</u>	54
<u>Signatures</u>	55

Table of Contents

CAUTION REGARDING FORWARD-LOOKING STATEMENTS

All statements in this quarterly report, 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 at 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, continue, and other similar terms. These forward-looking statements include, among other things, projections of our future financial performance and our anticipated growth, our accounting estimates, assumptions and judgments, the impact of new accounting pronouncements related to the expensing of stock options on our future results, 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, and our ability to successfully address new markets where competition is intense.

We caution readers that forward-looking statements are only 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. In addition to the other information in this quarterly report, we encourage you to review the information regarding the risks and uncertainties associated with our business set forth under the caption *Item 1A. Risk Factors* below and in our other filings with the United States Securities and Exchange Commission. 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. 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.

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

	March 31, 2006	December 31, 2005
Assets		
Current assets:		
Cash and cash equivalents	\$ 4,119	\$ 5,068
Short-term investments	76,781	77,120
Accounts receivable, net	7,047	5,911
Inventories	7,292	7,944
Other current assets	1,551	1,293
Total current assets	96,790	97,336
Property and equipment, net	4,151	4,398
Other assets and deferred charges	1,542	1,587
Total assets	\$ 102,483	\$ 103,321
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	\$ 3,537	\$ 5,414
Accrued compensation	1,501	1,499
Accrued expenses	1,357	1,651
Deferred revenue	78	8
Total current liabilities	6,473	8,572
Other non-current liabilities	56	54
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 52,855 and 52,761, respectively	53	53
Additional paid-in capital	440,686	439,163
Unearned stock compensation		(8)
Accumulated other comprehensive loss	(1,002)	(1,013)
Accumulated deficit	(343,783)	(343,500)
Total stockholders' equity	95,954	94,695

Edgar Filing: MICROTUNE INC - Form 10-Q

Total liabilities and stockholders' equity	\$ 102,483	\$ 103,321
--	------------	------------

See accompanying notes.

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

	Three Months Ended March 31,	
	2006	2005
Net revenue	\$ 15,525	\$ 12,181
Cost of revenue	7,402	5,815
Gross margin	8,123	6,366
Operating expenses:		
Research and development	4,714	4,003
Selling, general and administrative	4,651	4,102
Amortization of intangible assets		674
Total operating expenses	9,365	8,779
Loss from operations	(1,242)	(2,413)
Other income (expense):		
Interest income	903	505
Foreign currency gains (losses), net	59	(110)
Other	27	56
Loss before provision for income taxes	(253)	(1,962)
Income tax expense	30	43
Net loss	\$ (283)	\$ (2,005)
Basic and diluted net loss per common share	\$ (0.01)	\$ (0.04)
Weighted-average common shares used in computing basic and diluted loss per common share	52,813	51,977

See accompanying notes.

Net loss for the first quarter of 2006 included stock-based compensation expense under SFAS No. 123(R) of approximately \$1.4 million. See Note 1.

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

	Three Months Ended March 31,	
	2006	2005
Operating activities:		
Net loss	\$ (283)	\$ (2,005)
Adjustments to reconcile net loss to cash used in operating activities:		
Depreciation	375	514
Amortization of intangible assets		674
Foreign currency (gains) losses, net	(59)	110
Stock-based compensation	1,369	18
Gain on sale of assets		(49)
Changes in operating assets and liabilities:		
Accounts receivable, net	(1,136)	(504)
Inventories	652	875
Other assets	(213)	(1,596)
Accounts payable	(1,877)	(1,282)
Accrued expenses	(224)	(828)
Accrued compensation	2	(119)
Other liabilities	2	1
Net cash used in operating activities	(1,392)	(4,191)
Investing activities:		
Purchases of property and equipment	(128)	(273)
Proceeds from sale of assets		51
Proceeds from sale of available-for-sale investments	20,350	7,500
Purchase of available-for-sale investments	(20,000)	(25,000)
Net cash provided by (used in) investing activities	222	(17,722)
Financing activities:		
Proceeds from issuance of common stock	162	76
Net cash provided by financing activities	162	76
Effect of foreign currency exchange rate changes on cash	59	(110)
Net decrease in cash and cash equivalents	(949)	(21,947)
Cash and cash equivalents at beginning of period	5,068	34,515
Cash and cash equivalents at end of period	\$ 4,119	\$ 12,568

See accompanying notes.

Table of Contents

MICROTUNE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2006

(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 (IC) and subsystem module solutions for the cable, digital television (TV) and automotive 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 TV set-top boxes; cable high-speed data modems; cable high-speed voice modems enabling cable-based digital phone services; car audio, video and antenna amplifier systems; digital/analog TVs, including high-definition TVs; personal computer television (PC/TV) multimedia products; and mobile TVs. 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 TV and automotive 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 first quarter of 2006 and 2005 have been prepared by us, pursuant to the rules and regulations of the 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, 2005.

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 first quarter of 2006 and 2005 have been made. Results of operations for the first quarter of 2006 and 2005 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 TV 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 and on the successful development and marketing of new products in new and existing markets. Our future results also may be impacted by foreign currency fluctuations as a result of our international operations and foreign currency based revenues, and product warranty liabilities and line down clauses. See Item 1A. Risk Factors 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.

Use of Estimates

Edgar Filing: MICROTUNE INC - Form 10-Q

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 purchased intangible assets, 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

Table of Contents

MICROTUNE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2006

(unaudited)

estimates, judgments and assumptions can affect our reported assets and liabilities as of the date of the financial statements, as well as the reported 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 original 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 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 March 31, 2006, our short-term investments, which consist of corporate debt securities and other debt securities issued by United States government and state agencies, including auction-rate securities, included \$70.2 million of available-for-sale investments and \$6.6 million of held-to-maturity investments. The auction-rate securities in established markets are available to support current operations and are classified as short-term investments although their contractual maturities are greater than 10 years. At March 31, 2006, we held no long-term investments. The carrying values of our investments approximate their fair values. Our investments are reviewed periodically for other-than-temporary impairment. At March 31, 2006, the unamortized discounts on our investments were insignificant.

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 first quarter of 2006 and 2005 were insignificant. No allowance for doubtful accounts was recorded as of March 31, 2006 and December 31, 2005.

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. 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 first quarter of 2006 and 2005 was a charge (benefit) to cost of revenue of approximately \$(0.3) million and \$0.1 million, respectively.

Property and Equipment

Edgar Filing: MICROTUNE INC - Form 10-Q

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.

Table of Contents

MICROTUNE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2006

(unaudited)

Intangible Assets

Our intangible assets, which consist primarily of acquired patents and customer base, have been recorded as the result of our business or asset acquisitions. During the first quarter of 2005, the remaining unamortized intangible assets were being amortized on the straight-line basis over 3 years. Amortization expense on intangible assets was \$0.7 million for the first quarter of 2005. No amortization expense was recorded in the first quarter of 2006 as our intangible assets became fully amortized in the quarter ended September 30, 2005.

Impairment of Long-lived Assets

We review long-lived assets, including intangible 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 March 31, 2006 and December 31, 2005, the sales value of products shipped for which revenue was deferred was approximately \$0.5 million and \$0.2 million, respectively. All of the revenue deferred at December 31, 2005 was recognized during the first quarter of 2006.

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 first quarter of 2006 and 2005, we recognized 3% and 6%, 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 March 31, 2006 and December 31, 2005.

Edgar Filing: MICROTUNE INC - Form 10-Q

We grant limited stock rotation rights to certain distributors for qualifying product 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

Table of Contents

MICROTUNE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2006

(unaudited)

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.

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 were included in cost of revenue.

Warranty Costs

We generally provide a minimum of a one-year warranty on all products. 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. Foreign currency gains (losses), net were \$0.1 million and \$(0.1) million during the first quarter of 2006 and 2005, respectively.

Income Taxes

Our income taxes are computed using the asset and liability method of accounting. Under the asset and liability method, a deferred 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 tax benefits only to the extent, based on available evidence, that it is more likely than not that such benefits will be realized. Our deferred tax assets were fully reserved at March 31, 2006 and December 31, 2005.

Income (Loss) Per Share

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 subject to repurchase rights 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 first quarter of 2006 and 2005.

Edgar Filing: MICROTUNE INC - Form 10-Q

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

	March 31,	
	2006	2005
Stock options	9,352	6,777
Employee stock purchase plan	113	154
Total anti-dilutive securities excluded	9,465	6,931

Table of Contents

MICROTUNE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2006

(unaudited)

Stock-Based Compensation

Prior to January 1, 2006, we elected to follow Accounting Principles Board Opinion (APB) No. 25, *Accounting for Stock Issued to Employees*, and related interpretations to account for our employee and director stock options, as permitted by Statement of Financial Accounting Standards (SFAS) No. 123, *Accounting for Stock-Based Compensation*. We accounted for stock-based compensation for non-employees under the fair value method prescribed by SFAS No. 123. 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 employee stock options 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 Securities and Exchange Commission, 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 grant 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 grant-date fair value estimate in accordance with the provisions of SFAS No. 123(R). Results from prior periods have not been restated and do not include the impact of SFAS No. 123(R). Stock-based compensation expense under SFAS No. 123(R) for the first quarter of 2006 was \$1.4 million, relating to employee and director stock options and our employee stock purchase plan. Stock-based compensation expense under the provisions of APB No. 25 for the first quarter of 2005 was insignificant. See Note 8.

Stock-based compensation expense recognized each period is based on 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. In our pro forma disclosures required under SFAS No. 123 for periods prior to 2006, we accounted for forfeitures as they occurred.

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. These methods were previously used for our pro forma information required under SFAS No. 123.

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 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.

Prior to the adoption of SFAS No. 123(R), all tax benefits of deductions resulting from the exercise of stock options were required to be presented as operating cash flows in the Consolidated Statement of Cash Flows. 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 March 31, 2006.

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 income (loss) at March 31, 2006 includes foreign currency translation adjustments of \$1.0 million and unrealized gains or losses on investments.

Table of Contents

MICROTUNE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2006

(unaudited)

Risk Concentrations

Financial instruments that potentially expose Microtune to concentrations of credit risk consist primarily of trade accounts receivable. At March 31, 2006, approximately 55% 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 first quarter of 2006 and 2005, charges to write off uncollectible accounts were insignificant. As a result, we have not recorded an allowance for doubtful accounts as of March 31, 2006.

We depend on third-party foundries, primarily IBM 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, 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

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. 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. Subsystem Module Manufacturing Partner

On May 24, 2005, we entered into a five-year Manufacturing Agreement with Ionics, a leading provider of electronics manufacturing services in the Philippines. Ionics replaced Three-Five Systems (TFS) as our RF subsystem module manufacturing partner. The significant terms of the agreement are:

Ionics will manufacture, assemble and test our RF subsystem module solutions in its manufacturing facility in Manila, Philippines purchased from TFS on June 2, 2005;

Edgar Filing: MICROTUNE INC - Form 10-Q

Ionics will maintain, at its expense, our consigned equipment used in the manufacturing process;

We agreed on pricing terms for our current products, future pricing reductions for such products, and a pricing formula for our future products, taking into account our volume of activity with Ionics and Ionics' cost of material, labor and overhead; and

We agreed that Ionics could, under certain circumstances, require us to repurchase raw material inventories.

Table of Contents**MICROTUNE, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****March 31, 2006****(unaudited)**

As part of the Manufacturing Agreement, Ionics will manufacture our products on a purchase order basis. No purchase commitments were included in the agreement. The agreement has an initial term of five years and then automatically renews for successive one-year terms until terminated by either party by providing certain written notice at least one year prior to the end of the initial term or any renewal term.

On May 25, 2005, we entered into an Asset Purchase Agreement with TFS to purchase certain raw materials, work-in-process and finished goods inventories for approximately \$1.7 million. This purchase was completed on June 3, 2005. The raw materials and work-in-process inventory was used by Ionics to manufacture our RF subsystem module products. The majority of the purchased inventory was consumed in manufacturing our products and sold to customers in 2005.

As a condition to the closing of the TFS Asset Purchase Agreement described above, we entered into a Termination and Mutual Release with TFS on June 3, 2005 whereby the TFS Manufacturing Agreement dated as of March 27, 2003, which governed the manufacturing of our subsystem module products, was terminated. We further released each other from all liabilities, obligations and claims arising out of our former business relationship. The Termination and Mutual Release relieves TFS of all of its warranty obligations under the TFS Manufacturing Agreement; however, we were compensated by TFS to assume any warranty liability for all subsystem module products produced by TFS and still covered under our warranties to our customers. We do not believe that this warranty liability will have a material impact on our financial results. In conjunction with the asset purchase transaction, the mutual release of claims and the provision for future warranty obligations, we recorded a benefit to cost of revenue of approximately \$0.7 million in the second quarter of 2005.

3. Accounts Receivable, net

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

	March 31, 2006	December 31, 2005
Gross accounts receivable	\$ 7,328	\$ 6,143
Deferred revenue	(281)	(232)
Accounts receivable, net	\$ 7,047	\$ 5,911

4. Inventories

Inventories consist of the following (in thousands):

	March 31, 2006	December 31, 2005
Finished goods	\$ 4,069	\$ 4,768
Work-in-process	3,161	3,131
Raw materials	62	45
Total inventory	\$ 7,292	\$ 7,944

5. Accrued Expenses

Edgar Filing: MICROTUNE INC - Form 10-Q

Accrued expenses consist of the following (in thousands):

	March 31, 2006	December 31, 2005
Accrued non-cancelable inventory purchase obligations	\$ 381	\$ 359
Other	976	1,292
Total accrued expenses	\$ 1,357	\$ 1,651

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.

Table of Contents**MICROTUNE, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****March 31, 2006****(unaudited)****6. Income Taxes**

We have established a valuation allowance to fully reserve our net deferred tax assets at March 31, 2006 and December 31, 2005 due to the uncertainty of the timing and amount of future taxable income. During 2005, we adjusted our deferred tax assets and liabilities based on the completion of certain reconciliations and accordingly recorded a corresponding adjustment to our valuation allowance. For United States federal income tax purposes, at December 31, 2005, we had a net operating loss carryforward of approximately \$166.0 million and an unused research and development credit carryforward of approximately \$4.4 million, that will begin to expire in 2011. 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 first quarter of 2006 and 2005, 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 tax rates. The provision for taxes during the first quarter of 2006 and 2005 consists of foreign income taxes.

Our income tax returns and those of our subsidiaries are subject to review and examination in the various jurisdictions in which we operate. During the third quarter of 2005, we recorded a provision for income taxes of approximately \$0.1 million as a result of several ongoing foreign reviews and examinations. These foreign reviews and examinations were fully resolved and all tax liabilities were paid during the fourth quarter of 2005 and first quarter of 2006. The tax liabilities paid differed from the previously recorded provision by an insignificant amount. We have an ongoing review and examination in Germany in the ordinary course of business 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. We are in the early stages of this review and examination, believe that we have reasonable arguments for all income tax issues raised by the tax authorities and have not received a preliminary notification of any potential income tax liability. At March 31, 2006, we have not recorded a liability relating to this review and examination as no amount can be deemed probable based on information currently known to us. The outcome of this ongoing foreign review and examination is uncertain and the final resolution of the remaining income tax issues that have been raised as a result of this review and examination could have a material adverse impact on our financial position or future results of operations. To estimate the potential financial impact from an unfavorable outcome relating to this review and examination, we considered several compromise scenarios that could result if some or all of our arguments fail. As such, we estimate the potential liability to range from no liability to \$2.3 million.

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 will be calculated using the straight-line method over the lease term. We lease an administrative, sales and 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 March 31, 2006 are as follows (in thousands):

Year Ending December 31,	
2006	\$ 849
2007	901
2008	854
2009	850

Edgar Filing: MICROTUNE INC - Form 10-Q

2010	850
Thereafter	6,550
	\$ 10,854

Rent expense for the first quarter of 2006 and 2005 was \$0.3 million and \$0.3 million, respectively.

Table of Contents

MICROTUNE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2006

(unaudited)

Purchase Commitments

As of April 21, 2006, we had approximately \$11.7 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

We are currently subject to "line down" clauses in contracts with certain 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 product of a third party's intellectual property. As of March 31, 2006, we are unaware of any such 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 normal course of our business. The ultimate amount of liability, if any, for any pending claims of any type (either alone or combined) may materially and adversely affect our financial position, results of operations and liquidity. Moreover, the ultimate outcome of any pending 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 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.

Intellectual Property Litigation

From January 24, 2001 until June 13, 2004, Microtune and Broadcom Corporation were adverse parties in numerous litigation proceedings that related to patent infringement and anti-trust litigation. These proceedings were all dismissed under the terms of a settlement entered into on June 13, 2004. See our 2005 Annual Report on Form 10-K for a description of these proceedings and the settlement.

In October 2003, Broadcom requested that the United States Patent and Trademark Office (USPTO) re-examine certain claims of our U.S. Patent No. 5,737,035 ("035 patent") that were previously determined to be valid by a U.S. federal court. The USPTO issued an order granting the re-examination proceeding on January 8, 2004. On September 14, 2004, the USPTO examiner assigned to the re-examination issued an action with respect to the patentability of the '035 claims undergoing re-examination, confirming certain claims of the '035 patent and rejecting others. We responded to the examiner presenting our arguments that these rejected claims were patentable and should be confirmed. On June 20, 2005, the USPTO examiner issued a final office action, confirming certain claims of the '035 patent and rejecting others. On August 22, 2005, we submitted a response to the June final office action. On November 14, 2005, the USPTO removed the finality of the June office action and on January 23, 2006, the USPTO issued a replacement final office action. We responded to the USPTO and on April 11, 2006, the USPTO issued a Notice of Intent to Issue Ex Parte Reexamination Certificate indicating that the USPTO would issue a re-examination certificate terminating the re-examination proceedings.

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. We are aware of at least three such complaints: *Berger v. Goldman, Sachs & Co., Inc. et al.*; *Atlas v. Microtune et al.*; and *Ellis Investments Ltd. v. Goldman, Sachs & Co., Inc. et al.* The complaints are 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*

Edgar Filing: MICROTUNE INC - Form 10-Q

Litigation (IPO cases). The Atlas complaint names as defendants Microtune; Douglas J. Bartek, our former Chairman and Chief Executive Officer; Everett Rogers, our former Chief Financial Officer and Vice President of Finance and Administration; and several investment banking firms that served as underwriters of our initial public offering. Microtune, Mr. Bartek and Mr. Rogers were served with notice of the Atlas complaint on August 22, 2001, however, they have not been served regarding the other referenced complaints. The Berger and Ellis Investment Ltd. complaints assert claims against the underwriters only. The complaints were consolidated

Table of Contents

MICROTUNE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2006

(unaudited)

and amended on May 29, 2002. The amended 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. The amended complaint also alleges that false analyst reports were issued. No specific amount of damages is claimed. We are aware that 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 have been consolidated for pretrial purposes before the Honorable Shira A. Scheindlin. On February 19, 2003, the Court ruled on all defendants' motions to dismiss. The Court denied the motions to dismiss the 1933 Act Claims. The Court did not dismiss the 1934 Act Claims against us and other issuers and underwriters.

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. The settlement will require final approval of the Court, which cannot be assured.

On February 15, 2005, the Court issued an order providing preliminary approval of the settlement except to the extent the settlement would have cut off contractual indemnification claims that underwriters may have against securities issuers, such as Microtune. On September 1, 2005, the Court finalized its preliminary approval of the settlement. A hearing to consider final approval of the settlement was held on April 24, 2006 and the Court has not determined at this time whether to approve the settlement.

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 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 March 31, 2006, 52,854,599 rights were outstanding.

Stock Option Plans

In August 1996, our Board of Directors and the stockholders approved the 1996 Stock Option Plan that provides for incentive stock options and nonqualified stock options to be granted to key employees, certain directors, and consultants of Microtune. Our Board of Directors or designated committee establishes the terms of each option granted under the 1996 Stock Option Plan. The stock options granted under this plan generally

Edgar Filing: MICROTUNE INC - Form 10-Q

vest over 4 to 5 years and have a maximum contractual life of 10 years. At March 31, 2006, we had no options available for grant and 757,337 options granted and unexercised under the 1996 Stock Option Plan. At March 31, 2006, we had reserved 757,337 shares of common stock for issuance upon exercise of options granted pursuant to the 1996 Stock Option Plan.

Table of Contents**MICROTUNE, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****March 31, 2006****(unaudited)**

In August 2000, we adopted the 2000 Stock Plan. The 2000 Plan provides for incentive stock options and nonqualified stock options to be granted to key employees and consultants. Our Board of Directors or designated committee establishes the terms of each option granted under the 2000 Stock Plan. The stock options granted under this plan generally vest over 3 to 5 years and have a maximum contractual life of 10 years. At March 31, 2006, we had 3,281,824 options available for grant and 8,219,627 options granted and unexercised under the 2000 Plan. At March 31, 2006, we had reserved 11,501,451 shares of common stock for issuance upon exercise of options granted pursuant to the 2000 Stock Plan.

In August 2000, we adopted a Directors' Stock Option Plan. The Directors' Plan provides for nonqualified stock options to be granted to non-employee members of the Board of Directors. The stock options granted under this plan generally vest over 2 to 3 years and have a maximum contractual life of 10 years. At March 31, 2006, we had 561,000 options available for grant and 317,750 options granted and unexercised under the Directors' Stock Option Plan. At March 31, 2006, we had reserved 878,750 shares of common stock for issuance upon exercise of options granted pursuant to the Directors' Stock Option Plan.

On November 28, 2001, we assumed the obligations under Transilica's Stock Option Plan. The Transilica Stock Option Plan provided for incentive stock options and nonqualified stock options to be granted to key employees and consultants of Transilica. Their Board of Directors established the terms of each option granted under the Transilica Stock Option Plan at the time of grant. The stock options granted under this plan generally vest over 4 years and have a maximum contractual life of 10 years. At March 31, 2006, we had no options available for grant and 57,650 options granted and unexercised under the Transilica Stock Option Plan. At March 31, 2006, we had reserved 57,650 shares of common stock for issuance upon exercise of options granted pursuant to the Transilica Stock Option Plan.

A summary of our stock option activity and related information for the year ended December 31, 2005 and the first quarter of 2006 follows:

	Options Outstanding	
	Number of Shares	Weighted Average Exercise Price Per Share
Balance at December 31, 2004	6,726,862	\$ 2.94
Granted	3,298,260	3.94
Exercised	(519,316)	1.96
Canceled	(251,903)	3.63
Balance at December 31, 2005	9,253,903	\$ 3.33
Granted	259,500	5.39
Exercised	(93,572)	1.73
Canceled	(67,467)	3.32
Balance at March 31, 2006	9,352,364	\$ 3.40

The total intrinsic value of options exercised during the first quarter of 2006 was approximately \$0.3 million. During the first quarter of 2006, there were no significant grants to non-employees.

Table of Contents**MICROTUNE, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****March 31, 2006****(unaudited)**

The following presents certain information about outstanding stock options at March 31, 2006 (in thousands, except years and per share data):

Range of Exercise Price	Options Outstanding Weighted Average			Options Exercisable			
	Number	Remaining Contractual Life (Years)	Weighted Average Exercise Price	Aggregate Intrinsic Value	Number	Weighted Average Exercise Price	Aggregate Intrinsic Value
\$ 0.13 - \$ 0.20	28,167	1.5	\$ 0.14	\$ 143	28,167	\$ 0.14	\$ 143
\$ 0.38 - \$ 0.88	629,635	3.6	0.81	2,777	629,635	0.81	2,777
\$ 1.25 - \$ 1.85	163,253	5.5	1.53	602	122,051	1.52	452
\$ 1.94 - \$ 2.85	3,321,384	7.4	2.46	9,167	2,111,694	2.45	5,849
\$ 2.92 - \$ 4.35	3,431,334	9.0	3.77	4,975	377,906	3.44	673
\$ 4.47 - \$ 6.60	1,604,424	8.4	4.86	578	425,007	4.75	200
\$ 7.75 - \$10.40	65,067	5.2	9.30		65,067	9.30	
\$12.35 - \$15.45	106,100	5.3	13.81		95,717	13.95	
\$26.52 - \$37.88	3,000	4.6	28.41		3,000	28.41	
\$ 0.13 - \$37.88	9,352,364	7.8	\$ 3.40	\$ 18,242	3,858,244	\$ 2.91	\$ 10,094

The aggregate intrinsic value in the table above is based on the closing price of our common stock of \$5.22 as of March 31, 2006.

Employee Stock Purchase Plan

In August 2000, we adopted an Employee Stock Purchase Plan under Section 423 of the Internal Revenue Code. The plan allows eligible employees to purchase our common stock at 85% of the lower of the fair market value of the common stock at the beginning or end of each successive six-month offering period or their lowest respective purchase price under the plan's two-year lookback feature. Amounts deducted and accumulated by the participant will be used to purchase shares of common stock at the end of each purchase period.

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 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):

	Three Months Ended	
	March 31, 2006	March 31, 2005
Cost of revenue	\$ 10	\$

Edgar Filing: MICROTUNE INC - Form 10-Q

Research and development	540
Selling, general and administrative	815
Total stock-based compensation expense included in operating expenses	\$ 1,355
Total stock-based compensation expense	\$ 1,365 \$

Table of Contents**MICROTUNE, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****March 31, 2006****(unaudited)**

The following table presents the effect on net loss and net loss per share compared with pro forma information as if we had adopted SFAS No. 123 for the first quarter of 2005 (in thousands, except per share data):

	Three Months Ended	
	March 31, 2006	2005
Net loss, as reported for prior periods ⁽¹⁾	N/A	\$ (2,005)
Add stock compensation expense recorded under the intrinsic value method	N/A	18
Less stock-based compensation expense computed under the fair value method ⁽²⁾		(1,385)
Net loss, including the effect of stock-based compensation expense ⁽³⁾	\$ (283)	\$ (3,372)
Basic and diluted loss per common share, as reported in prior periods ⁽¹⁾	N/A	\$ (0.06)
Basic and diluted loss per common share, including the effect of stock-based compensation expense ⁽³⁾	\$ (0.01)	\$ (0.06)

(1) Net loss and net loss per share prior to 2006 did not include stock-based compensation expense under SFAS No. 123 because we did not adopt the recognition provisions of SFAS No. 123.

(2) Stock-based compensation expense prior to 2006 is calculated based on the pro forma application of SFAS No. 123.

(3) Net loss and net loss per share prior to 2006 represents pro forma information based on SFAS No. 123.

The weighted-average estimated value of the stock options granted during the first quarter of 2006 was approximately \$3.15 per share, using the Black-Scholes-Merton option-pricing formula with the following weighted-average assumptions:

	Three Months Ended	
	March 31,	
	2006	
Expected volatility	65.0%	
Risk-free interest rate	4.6%	
Expected dividends	0.0%	
Expected term (years)	5.0	

The expected volatility assumption was based upon a combination of historical stock price volatility and implied volatility consistent with SFAS No. 123(R) and SAB No. 107. The historical stock price volatility was measured on a weekly basis due to the relatively high volatility of the fair market value of our common stock. Due to the relatively low volume of the traded options on our common stock, we measured implied volatility using traded options with terms greater than 6 months. Expected volatility was calculated using 75% of the historical stock price volatility and 25% of the implied volatility.

The risk-free interest rate assumption was based upon the implied yields from the U.S. Treasury zero-coupon yield curve with a remaining term equal to the expected term of the options.

Edgar Filing: MICROTUNE INC - Form 10-Q

The expected term of employee stock options represents the weighted-average period the stock options are expected to remain outstanding and was based upon historical employee exercise behavior and expected employee turnover.

Our Employee Stock Purchase Plan has been deemed compensatory in accordance with SFAS No. 123(R). Stock-based compensation relating to this plan was estimated using a Black-Scholes-Merton option-pricing formula with assumptions previously disclosed under SFAS No. 123 as of the respective grant dates of the purchase rights provided to employees under the plan. The weighted-average estimated value of the purchase rights existing under this plan during the first quarter of 2006 was \$1.96. During the first quarter of 2006, we recognized approx. \$0.1 million of stock-based compensation expense as a result of this plan.

At March 31, 2006, the balance of unearned stock-based compensation to be expensed in future periods related to unvested share-based awards, as adjusted for expected forfeitures, is approximately \$9.9 million. The weighted-average period over which the unearned stock-based compensation is expected to be recognized is approximately 2 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. 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.

Table of Contents**MICROTUNE, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****March 31, 2006****(unaudited)****9. Geographic Information and Significant Customers**

Our corporate headquarters and principal design center are 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 \$0.6 million and \$0.2 million for the first quarter of 2006 and 2005, respectively. Net revenue by geographical area is summarized below (in thousands):

	Three Months Ended	
	March 31,	
	2006	2005
North America	\$ 5,763	\$ 5,375
Europe	2,833	2,182
Asia Pacific	6,928	4,595
Other	1	29
Total	\$ 15,525	\$ 12,181

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

	Three Months Ended	
	March 31,	
	2006	2005
Scientific-Atlanta (a Cisco company) ⁽¹⁾	23%	26%
Asuspower/Asustek ⁽²⁾	12%	11%
Ten largest customers ⁽³⁾	71%	72%

⁽¹⁾ Cisco Systems, Inc. (Cisco) completed its acquisition of Scientific-Atlanta on February 27, 2006. No revenue was generated from Cisco in the first quarter of 2006. Net revenue in the first quarter of 2005 excludes amounts attributed to Cisco.

⁽²⁾ Primarily for the benefit of ARRIS in the first quarter of 2006, and primarily for the benefit of ARRIS and Terayon in the first quarter of 2005

⁽³⁾ Includes respective manufacturing subcontractors

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

	March 31,	December 31,
	2006	2005
North America	\$ 2,992	\$ 3,139
Europe	855	893
Asia Pacific	304	366

Edgar Filing: MICROTUNE INC - Form 10-Q

Total

\$ 4,151

\$ 4,398

Table of Contents

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

Caution Regarding Forward-Looking Statements

All statements in this quarterly report, 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 at 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, continue, and other similar terms. These forward-looking statements include, among other things, projections of our future financial performance and our anticipated growth, our accounting estimates, assumptions and judgments, the impact of new accounting pronouncements related to the expensing of stock options on our future results, 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, and our ability to successfully address new markets where competition is intense.

We caution readers that forward-looking statements are only 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. In addition to the other information in this quarterly report, we encourage you to review the information regarding the risks and uncertainties associated with our business set forth under the caption *Item 1A. Risk Factors* below and in our other filings with the United States Securities and Exchange Commission (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. 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 Part II, Item 1A. and *Quantitative and Qualitative Disclosures About Market Risk* in Part I, Item 3. This section should also be read in conjunction with our Unaudited Consolidated Financial Statements and related Notes in Item 1.

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 (TV) and automotive 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 TV set-top boxes; cable high-speed data modems; cable high-speed voice modems enabling cable-based digital phone services; car audio, video and antenna amplifier systems; digital/analog TVs, including high-definition TVs; personal computer television (PC/TV) multimedia products; and mobile TVs. 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 TV and automotive markets.

We operate Microtune as a single business unit or reportable operating segment. 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 TV and automotive markets are intensely competitive and historically have seen rapid changes in demand. Our markets are also characterized as having short product life cycles due to rapid technological changes. This often results in rapidly decreasing average selling prices, which makes product cost reduction efforts, involving both product design and manufacturing processes, critical. The volatility of demand within our target markets makes it difficult for us to identify and discuss business trends or to predict future results.

Table of Contents

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

Cable

This market includes products that send and/or receive cable broadband signals. These products are designed for use in RF electronics, from upconverters in the cable head-end to tuners in consumer devices, including cable high-speed data modems, cable high-speed voice modems, and digital and analog set-top boxes.

Digital TV

This market includes products that receive terrestrial and cable signals. These products are designed for use in consumer electronics devices such as mobile (handheld) TVs; digital TVs, including high-definition TVs (including projection, Digital Light Processor (DLP[®]), plasma and liquid crystal display (LCD) systems); digital TV set-top converter boxes; satellite receivers that include a terrestrial tuner; VCRs; portable DVD players; digital personal video recorders (DVRs); and PC/TV multimedia products.

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 to components for emerging entertainment applications, including in-car TV, in-flight video, digital radio, such as 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 (cable) within the cable, digital TV and automotive markets. The devices or applications that our customers produce include cable TV set-top boxes; cable high-speed data modems; cable high-speed voice modems enabling cable-based digital phone services; car audio, video and antenna amplifier systems; digital/analog TVs, including HDTVs; PC/TV multimedia products; and mobile TVs. 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 revenues are generated through the efforts of our sales organization. However, we generated approximately 16% and 8% of our net revenue from sales made through distributors in the first quarter of 2006 and 2005, 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; 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.

Cost of Revenue and Gross Margin: Cost of revenue includes the cost of subcontracted materials, integrated circuit 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 and obsolete inventory. We also report expenses for the depreciation of our test and handling equipment and logistics in cost of revenue. The 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 cost efficiencies and inefficiencies; fluctuations in direct product costs such as wafer pricing and assembly, packaging and testing costs, and overhead costs; and provisions for excess or obsolete inventories. Stock-based compensation expense recorded in cost of revenue under SFAS No. 123(R) is expected to be insignificant as we use third-party contract manufacturers to produce the majority of our products enabling us to employ a limited number of production employees. Our

Edgar Filing: MICROTUNE INC - Form 10-Q

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 discuss cost of revenue and gross margin trends or to predict future results. We analyze absolute gross margin

Table of Contents

dollars and gross margin percentage. We also analyze the key drivers of gross margin, namely average selling price trends and the components of cost of revenue. The average selling price of our tuner ICs ranges generally from \$2 to \$3. The average selling price of our subsystem module products ranges generally from \$6 to \$25. Throughout the remainder of 2006, we expect the average selling price of our products to slightly decrease, which could have a material adverse impact on our financial condition and results of operations.

Operating Expenses: Operating expenses are substantially driven by personnel-related expenses, including stock-based compensation expense, lab supplies, training and prototype materials, professional fees and insurance expenses. Beginning January 1, 2006, stock-based compensation is recorded in operating expenses in accordance with SFAS No. 123(R) and will result 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 Expenses: 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 and long-term investments.

Liquidity and Cash Flows: Our cash flows are primarily driven by our net income. 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 and long-term investments, accounts receivable, days sales outstanding, inventory, inventory turns, and working capital as important indicators of our financial health.

Effective January 1, 2006, we adopted SFAS No. 123(R) using the modified-prospective-transition method. The adoption of SFAS No. 123(R) had a significant negative impact on our operating results in the first quarter of 2006 and is expected to have a significant negative impact on future periods. The following table presents the effect on net loss and net loss per share compared with pro forma information as if we had adopted SFAS No. 123 for the first quarter of 2005 (in thousands, except per share data):

	Three Months Ended	
	2006	March 31, 2005
Net loss, as reported for prior periods ⁽¹⁾	N/A	\$ (2,005)
Add stock compensation expense recorded under the intrinsic value method	N/A	18
Less stock-based compensation expense computed under the fair value method ⁽²⁾		(1,385)
Net loss, including the effect of stock-based compensation expense ⁽³⁾	\$ (283)	\$ (3,372)
Basic and diluted loss per common share, as reported in prior periods ⁽¹⁾	N/A	\$ (0.06)
Basic and diluted loss per common share, including the effect of stock-based compensation expense ⁽³⁾	\$ (0.01)	\$ (0.06)

(1) Net loss and net loss per share prior to 2006 did not include stock-based compensation expense under SFAS No. 123 because we did not adopt the recognition provisions of SFAS No. 123.

(2) Stock-based compensation expense prior to 2006 is calculated based on the pro forma application of SFAS No. 123.

(3) Net loss and net loss per share prior to 2006 represents pro forma information based on SFAS No. 123.

Table of Contents**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	
	2006	2005
Net revenue	100%	100%
Cost of revenue	48	48
Gross margin	52	52
Operating expenses:		
Research and development	30	33
Selling, general and administrative	30	34
Amortization of intangible assets		5
Total operating expenses	60	72
Loss from operations	(8)	(20)
Other income (expense)	6	4
Loss before provision for income taxes	(2)	(16)
Income tax expense		
Net loss	(2)%	(16)%

COMPARISON OF THE THREE MONTHS ENDED MARCH 31, 2006 AND 2005**Net Revenue**

The following table presents net revenue from each of our product types in the first quarter of 2006 as compared to the first quarter of 2005:

	Three Months Ended			
	2006	2005	Change	% Change
Silicon	\$ 11,401	\$ 8,395	\$ 3,006	35.8%
Modules	3,818	3,664	154	4.2
Other	306	122	184	150.8
Total	\$ 15,525	\$ 12,181	\$ 3,344	27.5%

The increase in net revenue in the first quarter of 2006 as compared to the first quarter of 2005 is primarily the result of increased shipments of silicon tuner and amplifier products for cable and digital TV markets, partially offset by decreased shipments of module products for cable and digital TV markets and decreased shipments of silicon upconverter products for cable markets. In addition, the increase in net revenue in the first quarter of 2006 is the result of increased shipments for automotive markets. Silicon tuner unit shipments increased approximately 41% from the first quarter of 2005 to the first quarter of 2006, primarily in cable and digital TV markets and module unit shipments increased by approximately 8%. We expect net revenues to grow approximately 15 to 20% in 2006, primarily due to design wins in the cable and digital TV markets and growth from existing designs.

Table of Contents

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

	Three Months Ended	
	March 31,	
	2006	2005
Scientific-Atlanta (a Cisco company) ⁽¹⁾	23%	26%
Asuspower/Asustek ⁽²⁾	12%	11%
Ten largest customers⁽³⁾	71%	72%

(1) Cisco Systems, Inc. (Cisco) completed its acquisition of Scientific-Atlanta on February 27, 2006. No revenue was generated from Cisco in the first quarter of 2006. Net revenue in the first quarter of 2005 excludes amounts attributed to Cisco.

(2) Primarily for the benefit of ARRIS in the first quarter of 2006, and primarily for the benefit of ARRIS and Terayon in the first quarter of 2005

(3) Includes respective manufacturing subcontractors

In the first quarter of 2006 and 2005, we recognized 3% and 6%, respectively, of our net revenue upon receipt of payment.

Cost of Revenue and Gross Margin

The following table presents cost of revenue and gross margin in the first quarter of 2006 as compared to the first quarter of 2005:

	Three Months Ended			
	March 31,			
	2006	2005	Change	% Change
Cost of Revenue	\$ 7,402	\$ 5,815	\$ 1,587	27.3%
Gross Margin	8,123	6,366	1,757	27.6
Gross Margin %	52.3%	52.3%	0.0 pts.	

Gross margin increased in the first quarter of 2006 as compared to the first quarter of 2005 primarily due to an approximate \$3.3 million increase in net revenue. Gross margin percentage in the first quarter of 2006 as compared to the first quarter of 2005 was positively impacted by increased revenue from our silicon products as a percentage of net revenue, which generally have a higher gross margin percentage compared to the mix of products sold in the first quarter of 2005, and increased revenue relating to inventory which had previously been written-off as excess. In contrast, gross margin in the first quarter of 2006 as compared to the first quarter of 2005 was negatively impacted by decreased shipments of silicon upconverter products for cable markets, which have a higher gross margin percentage compared to silicon tuner products, and increased shipments of silicon amplifiers, which have a lower gross margin percentage compared to other products. We expect our gross margin percentage to decrease in 2006 due to slight decreases in average selling prices in all products in the ordinary course of business.

Our cost of revenue for the first quarter of 2006 and 2005 did not include approximately \$0.4 million and \$0.2 million, respectively, of costs relating to the sale of inventory which had previously been written-off as excess. The net impact of changes in the inventory valuation allowances for the first quarter of 2006 and 2005 was a charge (benefit) to cost of revenue of approximately \$(0.3) million and \$0.1 million, respectively.

Table of Contents**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 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):

	Three Months Ended	
	March 31, 2006	2005
Cost of revenue	\$ 10	\$
Research and development		540
Selling, general and administrative		815
Total stock-based compensation expense included in operating expenses	\$ 1,355	
Total stock-based compensation expense	\$ 1,365	\$

Operating Expenses

The following table presents operating expenses for the first quarter of 2006 as compared to the first quarter of 2005:

	Three Months Ended			
	March 31,		Change	% Change
2006	2005			
Research and development	\$ 4,714	\$ 4,003	\$ 711	17.8%
Selling, general and administrative	4,651	4,102	549	13.4
Amortization on intangibles		674	(674)	(100.0)
Total	\$ 9,365	\$ 8,779	\$ 586	6.7%

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 first quarter of 2006 as compared to the first quarter of 2005 is primarily the result of an increase in personnel-related expenses resulting from increased average headcount and stock-based compensation expense, partially offset by a decrease in prototyping expenses for new silicon projects due to the timing of expenditures and a decrease in depreciation expense. Stock-based compensation expense related to research and development was approximately \$0.5 million in the first quarter of 2006 and insignificant in the first quarter of 2005. We expect research and development expenses to increase in 2006 as we intend to increase the number of RF IC and systems technical personnel.

We remain committed to significant research and development efforts to extend our technology leadership in the markets in which we operate. Currently, we hold 59 issued United States utility patents and have more than 37 additional United States patent applications pending. Our issued United States patents begin to expire in 2015. Our patents cover various aspects of our RF and analog technologies at the broad architectural, circuit and building-block levels.

Edgar Filing: MICROTUNE INC - Form 10-Q

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 legal, public relations and financial advisors. These expenses also include promotional and marketing costs, sales commissions and provisions for doubtful accounts.

Table of Contents

The increase in selling, general and administrative expenses in the first quarter of 2006 as compared to the first quarter of 2005 is primarily due to an increase in stock-based compensation expense, partially offset by a decrease in legal expenses, personnel-related expenses, directors and officers insurance expense and other insurance expenses. Stock-based compensation expense related to selling, general and administrative was \$0.8 million in the first quarter of 2006 and insignificant in the first quarter of 2005. Directors and officers insurance expense decreased as a result of a reduced annual premium effective September 2005. The results in the first quarter of 2005 include an approximate \$0.3 million reimbursement of legal expenses from our insurance carriers related to our securities and derivative litigation. See Part II, Item 1. Legal Proceedings. We expect selling, general and administrative expenses to increase slightly in 2006 in various expense categories driven by higher anticipated net revenue.

Amortization of Intangible Assets

In the first quarter of 2005, amortization of intangible assets resulted principally from our acquired patents. Our intangible assets were fully amortized as of September 30, 2005.

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 first quarter of 2006 and 2005:

	Three Months Ended		Change	% Change
	March 31,			
	2006	2005		
Interest income	\$ 903	\$ 505	\$ 398	78.8%
Foreign currency gains (losses), net	59	(110)	169	(153.6)
Other	27	56	(29)	(51.8)
Total	\$ 989	\$ 451	\$ 538	119.3%

The increase in interest income in the first quarter of 2006 as compared to the first quarter of 2005 is 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 provision for income taxes for the first quarter of 2006 and 2005:

	Three Months Ended		Change	% Change
	March 31,			
	2006	2005		
Income tax expense	\$ 30	\$ 43	\$ (13)	(30.2)%
Effective tax rate	(11.9)%	(2.2)%	(9.7) pts.	

Edgar Filing: MICROTUNE INC - Form 10-Q

In the first quarter of 2006 and 2005, 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 tax rates. The provision for taxes during first quarter of 2006 and 2005 consists 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 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 tax benefits only to the extent, based on available evidence, it is more likely than not such benefits will be realized. Our deferred tax assets were fully reserved at March 31, 2006 and December 31, 2005.

Table of Contents

For United States federal income tax purposes, at December 31, 2005, we had a net operating loss carryforward of approximately \$166.0 million and an unused research and development credit carryforward of approximately \$4.4 million, that will begin to expire in 2011. 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.

Our income tax returns and those of our subsidiaries are subject to review and examination in the various jurisdictions in which we operate. During the third quarter of 2005, we recorded a provision for income taxes of approximately \$0.1 million as a result of several ongoing foreign reviews and examinations. These foreign reviews and examinations were fully resolved and all tax liabilities were paid during the fourth quarter of 2005 and first quarter of 2006. The tax liabilities paid differed from the previously recorded provision by an insignificant amount. We have an ongoing review and examination in Germany in the ordinary course of business 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. We are in the early stages of this review and examination, believe that we have reasonable arguments for all income tax issues raised by the tax authorities and have not received a preliminary notification of any potential income tax liability. At March 31, 2006, we have not recorded a liability relating to this review and examination as no amount can be deemed probable based on information currently known to us. The outcome of this ongoing foreign review and examination is uncertain and the final resolution of the remaining income tax issues that have been raised as a result of this review and examination could have a material adverse impact on our financial position or future results of operations. To estimate the potential financial impact from an unfavorable outcome relating to this review and examination, we considered several compromise scenarios that could result if some or all of our arguments fail. As such, we estimate the potential liability to range from no liability to \$2.3 million.

Net Income (Loss)

The following table presents our net income (loss) for the first quarter of 2006 and 2005:

	Three Months Ended March 31,		Change	% Change
	2006	2005		
Net income (loss)	\$ (283)	\$ (2,005)	\$ 1,722	85.9%
Percent of net revenue	(1.8)%	(16.5)%	14.7 pts.	

The decrease in net loss in the first quarter of 2006 as compared to the first quarter of 2005 was primarily the result of an increase in net revenue, which resulted in an increase of \$1.8 million in gross margin, and an increase in interest income, partially offset by an increase in operating expenses due to stock-based compensation expense as described above.

Since inception we have incurred significant losses resulting in an accumulated deficit of approximately \$343.8 million as of March 31, 2006. 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 Part II, Item 1A., 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 continue to incur substantial losses from operations for 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.

Table of Contents**Liquidity and Capital Resources**

The following table presents key components of our liquidity and capital resources for the first quarter of 2006 and 2005 and at March 31, 2006 and December 31, 2005:

	Three Months Ended			
	March 31,		Change	% Change
	2006	2005		
Operating cash flows	\$ (1,392)	\$ (4,191)	\$ 2,799	(66.8)%
Investing cash flows	222	(17,722)	17,944	(101.3)
Financing cash flows	162	76	86	113.2
Capital expenditures	128	273	(145)	(53.1)
Days sales outstanding in accounts receivable	41	46	(5)	(10.9)
Inventory turns	4.1	3.7	0.4	10.8
	March 31,			
	2006		December 31,	
	2005		Change	
	2005		% Change	
Cash and cash equivalents	\$ 4,119	\$ 5,068	\$ (949)	(18.7)%
Short-term investments	76,781	77,120	(339)	(0.4)
Total	\$ 80,900	\$ 82,188	\$ (1,288)	(1.6)%
Accounts receivable, net	7,047	5,911	1,136	19.2
Inventories	7,292	7,944	(652)	(8.2)
Working capital	90,317	88,764	1,553	1.8

The decrease in cash used by operating activities resulted primarily from improved cash operating results and lower negative working capital changes in other assets and accrued expenses, partially offset by working capital changes in accounts receivable and accounts payable due to the timing of cash receipts and disbursements. Cash operating results improved in the first quarter of 2006 as compared to the first quarter of 2005 due to increased revenues, reduced cash operating expenses and increased interest income as described above.

In the first quarter of 2006, our primary source of cash from investing activities was the sale of available-for-sale investments, partially offset by the purchase of available-for-sale investments to achieve higher returns on our investments. Our primary use of cash from investing activities in the first quarter of 2005 was the purchase of available-for-sale investments.

In the first quarter of 2006 and 2005, our primary source of cash for financing activities was the exercise of employee stock options.

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 liquidity 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. Our investments, which consist of corporate debt securities and other debt securities issued by United States government and state agencies, including auction-rate securities, are comprised of high-quality securities purchased in accordance with our investment policy. The carrying value of our investments approximates their fair values. Our investments are reviewed periodically for other-than-temporary impairment. At March 31, 2006, the unamortized discounts on our investments were insignificant. In the aggregate, our cash, cash equivalents and short-term investments declined by approximately \$1.3 million during the first quarter of 2006 as a result of changes in working capital. We currently have no long-term debt. See Note 1 of Notes to Unaudited Consolidated Financial Statements.

Table of Contents

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 the level of future sales and our ability to manage expenses.

Future Contractual Commitments*Lease Commitments*

In the normal course of business, we may enter into leases for new or expanded facilities in both domestic and foreign locations. 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 will be calculated using the straight-line method over the lease term. We lease an administrative, sales and 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 March 31, 2006 are as follows (in thousands):

Year Ending December 31,	
2006	\$ 849
2007	901
2008	854
2009	850
2010	850
Thereafter	6,550
	\$ 10,854

Rent expense for the first quarter of 2006 and 2005 was \$0.3 million and \$0.3 million, respectively.

Purchase Commitments

As of April 21, 2006, we had approximately \$11.7 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

We are currently subject to line down clauses in contracts with certain 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 product of a third party's intellectual property. As of March 31, 2006, we are unaware of any such claims by any of our customers.

See Note 7 of Notes to Unaudited Consolidated Financial Statements.

CRITICAL ACCOUNTING POLICIES

Our discussion and analysis of our financial condition and results of operations are based on our Consolidated Financial Statements, which have been prepared in accordance with accounting principles generally accepted in the United States (GAAP). Note 1 of Notes to Unaudited Consolidated Financial Statements describes the significant accounting policies essential to our 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 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.

Table of Contents

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. 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 March 31, 2006 and December 31, 2005, the sales value of products shipped for which revenue was deferred was approximately \$0.5 million and \$0.2 million, respectively. All of the revenue deferred at December 31, 2005 was recognized during the first quarter of 2006.

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 first quarter of 2006 and 2005, we recognized 3% and 6%, 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 March 31, 2006 and December 31, 2005.

We grant limited stock rotation rights to certain distributors for qualifying product 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.

Table of Contents**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 first quarter of 2006 and 2005 were insignificant. No allowance for doubtful accounts was recorded as of March 31, 2006 and December 31, 2005.

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. 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 first quarter of 2006 and 2005 was a charge (benefit) to cost of revenue of approximately \$(0.3) million and \$0.1 million, respectively.

Income Taxes

Our income taxes are computed using the asset and liability method of accounting. Under the asset and liability method, a deferred 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 tax benefits only to the extent, based on available evidence, it is more likely than not such benefits will be realized. Our deferred tax assets were fully reserved at March 31, 2006 and December 31, 2005.

We have established a valuation allowance to fully reserve our net deferred tax assets at March 31, 2006 and December 31, 2005 due to the uncertainty of the timing and amount of future taxable income. During 2005, we adjusted our deferred tax assets and liabilities based on the completion of certain reconciliations and accordingly recorded a corresponding adjustment to our valuation allowance. For United States federal income tax purposes, at December 31, 2005, we had a net operating loss carryforward of approximately \$166.0 million and an unused research and development credit carryforward of approximately \$4.4 million, that will begin to expire in 2011. 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 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.

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 employee stock options 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 Securities and Exchange Commission, 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 grant 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 grant-date fair value estimate in accordance with the provisions of SFAS No. 123(R). Results from

Table of Contents

prior periods have not been restated and do not include the impact of SFAS No. 123(R). Stock-based compensation expense under SFAS No. 123(R) for the first quarter of 2006 was \$1.4 million, relating to employee and director stock options and our employee stock purchase plan. Stock-based compensation expense under the provisions of APB No. 25 for the first quarter of 2005 was insignificant.

Stock-based compensation expense recognized each period is based on 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. In our pro forma disclosures required under SFAS No. 123 for periods prior to 2006, we accounted for forfeitures as they occurred.

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. These methods were previously used for our pro forma information required under SFAS No. 123.

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 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 operation losses, we have not recorded the tax effects of employee stock-based compensation and have no APIC pool.

Prior to the adoption of SFAS No. 123(R), all tax benefits of deductions resulting from the exercise of stock options were required to be presented as operating cash flows in the Consolidated Statement of Cash Flows. 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 March 31, 2006.

At March 31, 2006, we have five stock-based compensation plans covering employees and directors, including four stock option plans and our employee stock purchase plan. During the first quarter of 2006, we granted our employees approximately 260,000 stock options with exercise prices ranging from \$4.77 to \$5.72 per share. The stock options generally vest over the following three to five years. The weighted-average estimated value of the stock options granted during the first quarter of 2006 was \$3.15 per share, using the Black-Scholes-Merton option-pricing formula with the following weighted-average assumptions:

	Three Months Ended
	March 31,
	2006
Expected volatility	65.0%
Risk-free interest rate	4.6%
Expected dividends	0.0%
Expected term (years)	5.0

The expected volatility assumption was based upon a combination of historical stock price volatility and implied volatility consistent with SFAS No. 123(R) and SAB No. 107. The historical stock price volatility was measured on a weekly basis due to the relatively high volatility of the fair market value of our common stock. Due to the relatively low volume of the traded options on our common stock, we measured implied volatility using traded options with terms greater than 6 months. Expected volatility was calculated using 75% of the historical stock price volatility and 25% of the implied volatility.

The risk-free interest rate assumption was based upon the implied yields from the U.S. Treasury zero-coupon yield curve with a remaining term equal to the expected term of the options.

The expected term of employee stock options represents the weighted-average period the stock options are expected to remain outstanding and was based upon historical employee exercise behavior and expected employee turnover.

Edgar Filing: MICROTUNE INC - Form 10-Q

Our Employee Stock Purchase Plan has been deemed compensatory in accordance with SFAS No. 123(R). Stock-based compensation relating to this plan was estimated using a Black-Scholes-Merton option-pricing formula with assumptions

Table of Contents

previously disclosed under SFAS No. 123 as of the respective grant dates of the purchase rights provided to employees under the plan. The weighted-average estimated value of the purchase rights existing under this plan during the first quarter of 2006 was \$1.96. During the first quarter of 2006, we recognized approx. \$0.1 million of stock-based compensation expense as a result of this plan.

At March 31, 2006, the balance of unearned stock-based compensation to be expensed in future periods related to unvested share-based awards, as adjusted for expected forfeitures, is approximately \$9.9 million. The weighted-average period over which the unearned stock-based compensation is expected to be recognized is approximately 2 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. 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 of 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 position.

Our future cash commitments are primarily for long-term facility leases. In April 2005, we extended our operating lease for our corporate headquarters in Plano, Texas an additional 10 years with certain rights of early termination with corresponding penalties, reducing the monthly base rent and providing a leasehold improvement allowance. This lease extension also included a brief rent abatement and escalating rent payments. Our lease for our Germany facility features an option to purchase the facility during certain time periods during the lease. The lease has a twenty-two year term, which began in December 1999. See Note 7 of Notes to Unaudited Consolidated Financial Statements.

OTHER FINANCIAL INFORMATION

Subsystem Module Manufacturing Partner

On May 24, 2005, we entered into a five-year Manufacturing Agreement with Ionics EMS, Inc. (Ionics), a leading provider of electronics manufacturing services in the Philippines. Ionics replaced TFS as our RF subsystem module manufacturing partner. See Note 2 of 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, 2005.

Table of Contents

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 in the Securities and Exchange Commission'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 March 31, 2006 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Table of Contents

PART II .

OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

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

ITEM 1A. RISK FACTORS

Our success depends on the growth of the cable, digital TV and automotive markets generally and the demand for RF products within these markets specifically.

We derive a substantial portion of our revenue from sales of RF products into markets related to cable, digital TV and automotive applications or devices. These markets are characterized by:

intense competition;

rapid technological change;

long design cycles with design windows open intermittently; and

short product life cycles, especially in the PC and consumer electronics markets.

The cable, digital TV and automotive markets may not grow in the future as anticipated, if at all, or a significant market slowdown may occur. Further, demand for applications or devices that include our products, in particular, cable set-top boxes; high-speed cable data modems; high-speed cable voice modems enabling cable based digital phone services; car audio, video and antenna amplifier systems; digital/analog TVs, including high-definition TVs; PC/TV multimedia products and mobile TVs may not grow at a rate sufficient for us to sustain profitability, or our customers' market share may decline, even though demand in general is high, which would also adversely affect our financial results. In addition, since the mobile TV market segment is a new market, and its development is subject to many contingencies and unknowns, it may develop much slower than currently expected or it may not develop at all. Because of the intense competition in the cable, digital TV and automotive markets, the unproven technology of many products addressing these markets and the short product life cycles of many consumer applications or devices, it is difficult to predict the potential size and future growth rate of the markets for our RF products. In addition, the cable, digital TV and automotive markets are transitioning from analog to digital, as well as expanding to new services, such as interactive television, mobile TV and on-demand services. The future growth of our RF product markets is dependent upon market acceptance of our customers' applications and devices, incorporating our RF technology, that address the cable, digital TV and automotive markets, and we cannot assure you that our customers' products and consequently, our underlying RF technology, will be accepted by any of the end customers in these markets. If the demand for our RF products is not as great as we expect, if we are unable to produce competitive products to meet that demand or if we are otherwise unable to capitalize on market opportunities, we may not be able to generate revenue growth or profitability.

Market specific risks affecting the mobile TV market segment within the digital TV market could impair our ability to compete successfully in this new market segment.

The market for mobile TV is new and is characterized by various market-specific risks, any of which may adversely affect our ability to compete in this new market segment.

Examples of market-specific risks affecting the mobile TV market segment include:

Edgar Filing: MICROTUNE INC - Form 10-Q

the risk that the mobile TV market segment may develop more slowly than expected or not develop at all;

the risk that we will fail to achieve or continue to achieve design wins with major cell phone manufacturers;

the risk that we will fail to effectively partner with strategic demodulator partners who are necessary to effectively market our products and secure design wins with major cell phone manufacturers or that even if we are initially successful in partnering with such strategic demodulator partners, that they will develop or market their own tuner, system-in-package (SIP) or system-on-chip (SOC) mobile TV solutions rather than continuing to market our joint solution;

Table of Contents

the risk that other companies with more focused engineering efforts will compete effectively against us;

the risk that we may overallocate our engineering resources to the development of mobile TV products, only to fail to penetrate this market segment and consequently, harm other areas of our product development;

the risk that even if we are successful initially, we may have difficulty sustaining our market position as the mobile TV market segment will likely be highly competitive with extreme pricing pressure and price erosion;

the risk that solutions that integrate the tuner and demodulator on one chip (SOC) or in one package (SIP) will be more compelling to potential customers than our discrete silicon tuner solutions;

the risk that SIP or SOC solutions will be adopted as the preferred implementation by mobile phone manufacturers and we will fail to successfully partner with a demodulator manufacturer to support a SIP or SOC solution;

the risk that tuners fabricated in CMOS to enable or to aid integration with the CMOS demodulator in a SIP or SOC solution will be favored over our tuner solutions fabricated in SiGe; and

the risk that mobile TV broadcasting formats other than DVB-H, such as MediaFLO, that our products do not currently support will gain greater acceptance than DVB-H and possibly become the universally adopted standard in the mobile TV market segment.

To the extent our efforts to penetrate the mobile TV market segment 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.

Market-specific risks affecting the television, digital TV set-top converter box and television peripheral market segment of the digital TV market could impair our ability to compete successfully in that market.

The market for digital TV applications in televisions, digital TV set-top converter boxes 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 this market segment 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;

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 suppliers of module tuners who currently sell tuners to television manufacturers that we are currently targeting with our silicon tuners, may dramatically lower their prices (including to levels below their costs) in order to protect their existing relationships, thereby making our silicon tuners undesirable from an economic standpoint;

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

Edgar Filing: MICROTUNE INC - Form 10-Q

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;

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; and

Table of Contents

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

Our efforts to penetrate the digital TV market, in particular, will depend on our ability to overcome the challenges described above and upon eventual acceptance of our new digital TV 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.

If we do not complete our design-in activities before a customer's design window closes, we will lose the design opportunity which could have a material adverse impact on our business, results of operations and future prospects.

The timing of our design-in activities with key customers and prospective customers may not align with their open design windows, which may or may not be known to us, making design win predictions more difficult and substantially delaying revenue growth from certain target customers. It may be difficult for us to determine our customer's design window timing. If we miss a particular customer's design window, we may be forced to wait an entire year or even longer for the next opportunity to compete for the customer's next design. Because the timing of our design-in activities with key customers and prospective customers are not always aligned with these customers' open design windows, it is extremely difficult for us to make design win predictions. Any failure to complete a design-in during a customer's design window may substantially delay revenue growth from certain target customers and markets, which could have a material adverse effect on our business, results of operations and future prospects.

Other solutions for the cable, digital TV and automotive markets compete with some of our solutions. If these solutions prove to be more reliable, faster, less expensive or more popular than our solutions, the demand for our RF products and our revenue may decrease.

Some of our target market segments, such as cable modem and cable telephony services, are competing with a variety of non-RF based broadband communications solutions, including digital subscriber line (DSL) technology and certain fiber to the home solutions. Many of these technologies compete effectively with cable modem and cable telephony services and do not require RF tuners like the ones that we sell. If any of these competing technologies are, or are perceived to be, more reliable, faster, less expensive, able to reach more customers or have other advantages over RF broadband technology, the demand for our RF products may decrease, which would cause our revenue to decrease accordingly. Also, some of the consumer devices that currently incorporate our RF products, e.g., TV's, may not use our tuners or other products we sell in the future. Such changes in device features or functionality could adversely affect our financial results and business prospects.

We operate in an intensely competitive business and many of our competitors have significantly greater resources and operating flexibility, which allow them to compete effectively against us in existing markets and may affect our ability to enter or effectively compete in new markets.

The markets in which we compete are intensely competitive and we cannot assure you that we will be able to compete successfully against current or new competitors. This competition has resulted and may continue to result in declining average selling prices for our RF products and a corresponding reduction in our ability to recover research and development and manufacturing costs. We expect competition to continue to increase as industry standards become well known and as other competitors enter our target markets. We compete with, or may in the future compete with, a number of major domestic and international suppliers of integrated circuit and system modules in the cable, digital TV and automotive markets. We compete primarily with Alps, Anadigics, Broadcom, DiBcom, Freescale, LG Innotek, Mitsumi, Panasonic, Philips Electronics, RF Magic, Samsung Electro-Mechanics, Sanshin, Sanyo, Sharp, Siano, Texas Instruments, Thomson, Xceive and Xuguang. Average selling prices for products offered by competitor tuner module manufacturers continue to erode substantially, causing our silicon product offerings to be less attractive to potential customers and further limiting our design win opportunities, especially in the digital TV market.

Many of our current and potential competitors have advantages over us, including:

longer operating histories and established market positions in key markets;

greater name recognition;

Table of Contents

access to larger customer bases;

significantly greater financial, sales and marketing, manufacturing, distribution, management, technical and other resources;

existing relationships with potential customers as a result of the sales of other components, which can be leveraged into sales of products competitive with our RF products;

existing relationships with partners in joint ventures or investing activities, which can be leveraged into sales of products competitive with our RF products; and

broader product and service offerings that may allow them to compete effectively by bundling their tuner products with their other products and services, by legal or illegal means.

As a result, our competitors may be able to adapt more quickly to new or emerging technologies and changes in customer requirements and may be able to devote greater resources to the development, promotion and sale of their products which may harm our current market position and impact our ability to enter or compete effectively in new markets. If we do not compete successfully, we may lose market share in our existing markets, our gross margins may fail to increase or may decline, and we may experience other material adverse effects on our business, financial condition and results of operations.

Our success is highly dependent on our relationships with our strategic demodulator partners.

Our RF products are designed to be interoperable with various specific demodulator integrated circuit products that are designed and manufactured by other companies. Historically, we have relied on informal strategic relationships with various demodulator manufacturers to enable both parties to offer an interoperable tuner/demodulator solution to our mutual end customers. Although we work in concert with our third-party demodulator partners to complete highly functional reference designs, we have no control over our partners' future product plans and product roadmaps and could be effectively designed out of future customer applications by the refusal of a demodulator partner to continue to support us. Likewise, our ability to acquire new customers is highly dependent on the cooperation of third-party demodulator manufacturers. If such third-party manufacturers decide to partner with our competitors or to provide their own tuner solution, we would effectively be prevented from selling our products to potential new customers. This risk is especially present in the mobile TV market segment, where there are currently few demodulator partners and many tuner competitors. Furthermore, our dependence on these third-party demodulator manufacturers often limits the strategic direction of the company. If we were to design products that were competitive with any of such demodulator manufacturers, they may choose to stop working with us.

Our current principal demodulator partners are Texas Instruments in the cable modem market, ATI Technologies in the ATSC market and ST Microelectronics in the DVB- T and DVB-C markets. Our tuners are frequently used with demodulators from other companies not considered a principal demodulator partner. In the mobile TV market, our tuner is currently marketed with a DiBcom demodulator; however, DiBcom has recently announced its plans to offer a SIP solution, incorporating its own internally developed RF silicon tuner. Texas Instruments is currently offering its own single chip integrated tuner and demodulator, the Hollywood chip, which will compete directly with our mobile TV tuner products and our joint solutions offered with our demodulator partners.

If any of our current or prospective demodulator partners were to stop working with us in favor of other tuner manufacturers or in favor of deploying their own tuner products, we would be effectively designed out of current and potential customer's products and this would have a material adverse effect on our business, results of operations and our future prospects.

Industry participants may consolidate or establish financial or strategic relationships, adversely impacting our ability to compete in our markets.

Consolidation by industry participants, such as acquisitions of our customers, suppliers or partners by our competitors, or acquisitions of our competitors by our customers, suppliers or partners, could result in competitors with increased market share, larger customer bases, greater diversified product offerings and greater technological and marketing expertise, which would allow them to compete more effectively against us. Current and potential competitors may also gain such competitive advantages by establishing financial or strategic relationships with existing or potential customers, suppliers or other third-parties. These new competitors or alliances among competitors could emerge rapidly and acquire

significant market share. In

Table of Contents

addition, some of our suppliers or partners offer or may offer products that compete with our RF products. Further, we rely upon some of our partners for certain joint reference design and marketing activities and some of our products are incorporated in some of our partners' reference designs that are provided to potential customers. Depending on the participants, industry consolidation or the formation of strategic relationships could have a material adverse effect on our business and results of operations by reducing our ability to compete successfully in our current markets and the markets we are seeking to serve.

Our success could be jeopardized by the loss of key personnel or an inability to attract qualified candidates.

Any success we may have in the future, including our ability to grow and support future customers, will depend to a significant degree upon the continued service of our personnel, particularly our key personnel and executive management. The members of our executive management team are not generally parties to employment agreements with Microtune. The loss of one or more members of our executive management team or other key personnel could have an adverse effect on our operations.

Our future success also depends on our ability to attract, retain and motivate qualified personnel with experience in RF engineering, integrated circuit design and software and technical marketing and support. We are extremely dependent on certain key engineering personnel. Should we lose one or more of these key engineering personnel, it would have a material adverse effect on our ability to design our products and support our customers.

Additionally, if we do not meet our hiring targets, we may be unable to support our key prospective customers and we may lose the ability to enter large emerging markets, resulting in a material adverse effect on our future prospects.

We rely heavily upon equity compensation incentives, such as options to purchase our common stock to attract, retain and motivate such personnel. The equity incentives of our competitors and other elements of our competitors' compensation structures, particularly cash compensation, may be significantly more attractive than the compensation packages we offer.

With respect to retaining personnel, the market price of, or other price attainable for, our common stock directly affects the relative attractiveness and effectiveness of our stock options as a recruiting and retention tool. In the past, our common stock price has been substantially higher than currently prevailing prices. Any future poor operating performance we experience may cause the price of our common stock to decline from current levels. In addition, due to the recent issuance of SFAS No. 123(R), Share-Based Payment, requiring companies to recognize the cost of employee services received in exchange for awards of equity instruments in the financial statements, we may change our strategy for compensating employees. A lower market price of our common stock, along with any related deterioration in the morale of our personnel regarding this component of their compensation, may result in our loss of personnel, including key personnel and executive management. These personnel losses could reasonably be expected to have a prompt, material and adverse effect on our business and operations.

Additionally, we may have to explore the possibility of opening design centers in locations where attractive candidates prefer to live. We opened a design center in Plantation, Florida in February 2006 in order to acquire additional engineering talent.

The competition for attracting qualified candidates is intense, particularly so in the RF silicon and RF systems industries. Our ability to attract qualified candidates is essential to any success we may have in the future. For the reasons described above, there can be no assurance that we will be able to continue to attract, retain and motivate qualified technical, management, and other candidates necessary for the design, development, manufacture and sale of our RF products in the future.

We expect our quarterly results of operations to fluctuate.

Our quarterly results of operations have fluctuated significantly in the past and we expect such results to fluctuate significantly in the future due to a number of factors, many of which are not in our control. These factors may include:

the timing, cancellation and rescheduling of significant customer orders;

the ability of our customers to procure the other necessary components for their end-products that utilize our products in order to conduct their operations;

Edgar Filing: MICROTUNE INC - Form 10-Q

pricing concessions on volume sales to particular customers for established time frames and our ability to respond to general downward pressure on the average selling prices of our products;

Table of Contents

cyclical or seasonal slowdowns and general downturns in customer demand or related industry-wide increases in inventories;

our ability to predict our customers' demand for our products, manage production and inventory levels in response to product life cycles and other factors and minimize the effects of obsolete or excessive inventory;

design wins and changes in our product and customer mix;

labor disputes at our subsystem module manufacturer's facility in the Philippines or at any of our other subcontractors, which may cause temporary slowdowns or shutdowns of operations;

problems with our products that result in significant returns;

inadequate allocation of wafer, assembly or test capacity for our silicon products by our subcontractors and/or allocation of components used in our module products by our suppliers;

inconsistent or non-linear quarterly revenue that may result from our entry into new markets, such as mobile TV, or new consumer products, such as digital TV set-top converter boxes because our customers may have difficulty accurately determining the initial demand for their new products;

acts of terrorism or military action occurring anywhere in the world; and

acts of God or force majeure.

It is likely that our quarterly results of operations will be adversely affected by one or more of the factors listed above, or other factors. If our future results of operations fail to meet the expectations of stock market analysts or investors, the market price of our common stock may decline.

Because we depend on a few significant customers for a substantial portion of our revenue, the loss or change in demand of a key customer would seriously harm our business.

We have historically derived a substantial portion of our revenue from sales to a relatively small number of customers and we expect this trend to continue. The loss of any significant customer would significantly harm our revenue. Sales to our significant customers, including sales to their respective manufacturing subcontractors, as a percentage of net revenue were as follows:

	Three Months Ended	
	March 31,	
	2006	2005
Scientific-Atlanta (a Cisco company) ⁽¹⁾	23%	26%
Asuspower/Asustek ⁽²⁾	12%	11%
Ten largest customers ⁽³⁾	71%	72%

⁽¹⁾ Cisco Systems, Inc. (Cisco) completed its acquisition of Scientific-Atlanta on February 27, 2006. No revenue was generated from Cisco in the first quarter of 2006. Net revenue in the first quarter of 2005 excludes amounts attributed to Cisco.

Edgar Filing: MICROTUNE INC - Form 10-Q

- (2) Primarily for the benefit of ARRIS in the first quarter of 2006, and primarily for the benefit of ARRIS and Terayon in the first quarter of 2005
- (3) Includes respective manufacturing subcontractors

Further, several existing and potential customers have substantial internal technological capabilities and could develop products internally that compete with or replace our products. A decision by any of our significant customers to internally design and manufacture products that compete with our products could have a material adverse effect on our business and results of operations.

We believe that our future results of operations will continue to depend on the success of our largest customers, on our ability to sell existing and new products to these customers in significant quantities and on our ability to diversify our customer base. To attract new customers or retain existing customers, we may offer certain customers very attractive prices on our products which could impact our overall pricing strategy. In that event, our average selling prices and gross margins would decline. The loss of a key customer or a reduction in our sales to any key customer would harm our revenue and consequently our results of operations and financial condition.

Table of Contents

We are subject to order and shipment uncertainties with respect to our RF products, and if we are unable to accurately predict customer demand for these products, we may incur excess or obsolete inventory, which would reduce our profit margin, or insufficient inventory, which would result in lost revenue opportunities and potentially in loss of market share and damaged customer relationships.

Our sales are typically made pursuant to individual purchase orders, and we generally do not have long-term supply arrangements with our customers, including our most significant customers, in terms of volume of sales. Our terms and conditions (which do not apply to some of our key customers) typically provide that our customers may cancel orders scheduled to ship outside 90 days. Further, our terms typically provide that customers may reschedule orders that are scheduled to ship outside 30 days, but customers typically are restricted to the number of days they can delay the ship date. However, we have permitted customers to cancel orders less than 90 days before the expected date of shipment and to re-schedule shipments less than 30 days before the expected date of shipment, with little or no penalty. We currently do not have the ability to accurately predict what or how many products our customers will need in the future. Anticipating demand is difficult because our customers face volatile pricing and unpredictable demand for their own products and are increasingly focused on cash preservation and tighter inventory management. However, we place orders with our suppliers based on forecasts of customer demand and, in some instances, may establish buffer inventories to accommodate anticipated demand. Our forecasts are based on multiple assumptions, each of which may introduce error into our estimates. If we overestimate customer demand, we may allocate resources to manufacturing products that we may not be able to sell when we expect to, or at all. As a result, we would hold excess or obsolete inventory, which would reduce our profit margins and adversely affect our business and results of operations. Conversely, if we underestimate customer demand or if insufficient manufacturing capacity is available, we would forego revenue opportunities and potentially lose market share and damage our customer relationships. In addition, any future significant cancellations or deferrals of product orders or the return of previously sold products could materially and adversely affect our profit margins, increase product obsolescence and restrict our ability to fund our operations.

The average selling price of our products will likely decrease over time. If the selling price reductions are greater than we expect, our results of operations may be adversely affected.

Historically, the average selling price of our products has decreased over their lives. In addition, as the markets for RF integrated circuit and module products mature, we believe that it is likely that the average unit prices of our RF products will decrease in response to competitive pricing pressures, increased sales discounts, new product introductions, competitive product bundling and a transition in our markets from higher priced module products to lower priced integrated circuits. To offset these decreases, we expect to primarily rely on achieving cost reductions for materials used in existing products and introducing new products that can either be sold at higher average selling prices or be manufactured with lower costs.

Although we will seek to increase the sales of our higher margin products, our sales and product development efforts may not be successful and our new products may not achieve market acceptance. To the extent we are unable to reduce costs or sell our higher margin products, our results of operations may be adversely affected.

The sales cycle for our RF products is long, and we incur substantial non-recoverable expenses and devote significant resources to sales that may not be realized when anticipated, if at all.

Our customers, and sometimes their customers, typically conduct significant evaluation, testing, implementation and acceptance procedures before they purchase our RF products. These evaluation processes are frequently lengthy and may range from three months to one year or more. As a result, we expend significant financial and human resources to develop customer relationships before we realize any revenue from these relationships. In fact, we may never realize any revenue from these efforts. In many situations, our customers design their products to specifically incorporate our RF products, and our RF products must be designed to meet their stringent specifications. This process can be complex and may require significant engineering, sales, marketing and management effort on our part. This process may also require significant engineering and testing by our customers and, if our customers do not have sufficient capabilities to complete the process, they may become dissatisfied with our products, and our business and results of operations could be materially adversely affected.

Table of Contents

We customize a substantial portion of our RF subsystem module products to address our customers' specific RF needs. If we do not sell our customer-specific products in large volumes, we may be unable to cover our fixed costs or may be left with substantial unsaleable inventory.

We manufacture a substantial portion of our RF subsystem module products to address the unique needs of our individual customers. Frequent product introductions by systems manufacturers make our future success dependent on our ability to select development projects that will result in sufficient volumes to enable us to achieve manufacturing efficiencies to cover our fixed costs. Because some of our customer-specific RF module products are developed for unique applications, we expect that some of our current and future customer-specific RF module products may never be produced in sufficient volume to cover our fixed costs. In addition, if our customers fail to purchase these customized RF module products from us, we risk having substantial unsaleable inventory, which could have a material adverse effect on our financial condition and results of operations.

A product recall by a major customer could materially adversely affect our business, financial condition and results of operations.

We generally warrant our commercial products for a period of one year, and longer for automotive electronics products. If a customer experiences a problem with our products and subsequently returns our products to us in large quantities for rework, replacement, or refund, the cost to us could be significant and could have a material adverse effect on our business, financial condition and results of operations.

Some of our customers require us to sign line down clauses, liability clauses and/or intellectual property warranty and indemnification clauses.

We are currently subject to line down clauses in contracts with certain customers. Such clauses require us to pay financial penalties if our failure to supply products in a timely manner causes the customer to slow down or stop their production. Such penalties could be large and, if incurred, could have a material adverse effect on our financial condition and results of operations. We are also subject to product liability clauses and intellectual property warranty and indemnification provisions in some of our customer contracts, and where we do not have contracts, we are subject to such default provisions in the relevant jurisdiction's embodiment of the Uniform Commercial Code. Such clauses and warranties 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. Such penalties or obligations could be large and, if incurred, could have a material adverse effect on our financial condition and results of operations.

Our inability to maintain or grow revenue from international sales could harm our financial results.

Net revenue from outside of North America was 63% and 56% for the first quarter of 2006 and 2005, respectively. We plan to increase our international sales activities by adding international sales personnel, sales representatives or distributors. Our international sales will be limited if we cannot do so. Even if we are able to expand our international operations, we may not succeed in maintaining or increasing international market demand for our products which could have a material adverse effect on our financial condition and results of operations.

A majority of our revenues have historically come from our international customers, and, as a result, our business may be harmed by political and economic conditions in foreign markets and the challenges associated with operating internationally.

Historically, revenues from international markets have represented the majority of our total revenues. We expect revenues from international markets to continue to represent the majority of our total revenues for the foreseeable future. International business activities involve certain risks, including:

difficulties involved in the staffing and management of our geographically dispersed operations;

longer sales cycles in certain countries, especially on initial entry into a new geographical market;

greater difficulty in evaluating a customer's ability to pay, longer accounts receivable payment cycles and greater difficulty in the collection of past-due accounts;

Table of Contents

general economic conditions in each country;

challenges associated with operating in diverse cultural and legal environments;

seasonal reductions in business activity specific to certain markets;

loss of revenues, property and equipment from expropriation, nationalization, war, insurrection, terrorism and other political risks;

foreign taxes and the overlap of different tax structures, including modifications to the United States tax code as a result of international trade regulations;

greater difficulty in safeguarding intellectual property;

foreign technical standards;

import and export licensing requirements, tariffs, and other trade and travel restrictions; and

existence or adoption of laws and regulations affecting the operation and taxation of our business and the general business climate for foreign companies.

We extend credit to our customers, sometimes in large amounts, but there is no guarantee every customer will be able to pay our invoices when they become due. At various times, our accounts receivable is concentrated in a few customers.

As part of our routine business, we extend credit to customers purchasing our products. At March 31, 2006, approximately 55% of our net accounts receivable were due from five of our customers. While our customers may have the ability to pay on the date of shipment or on the date credit is granted, their financial condition could change and there is no guarantee that customers will ever pay the invoices.

Because all of our customers do not have the same credit terms, our outstanding accounts receivable balance can become concentrated in a smaller number of customers than our overall net revenue. This concentration can subject us to a higher financial risk.

Our customers' products are subject to governmental regulation.

Governmental regulation could place constraints on our customers and consequently reduce their demand for our RF products. The Federal Communications Commission, or FCC, has broad jurisdiction over several of our target markets in the United States. Similar governmental agencies regulate our target markets in other countries. Although most of our products are not directly subject to current regulations of the FCC or any other federal or state communications regulatory agency, much of the equipment into which our products are incorporated is subject to direct government regulation. Accordingly, the effects of regulation on our customers or the industries in which they operate may, in turn, impede sales of our products. For example, demand for our RF products will decrease if equipment incorporating our products fails to comply with FCC emissions specifications.

Our dependence on a single manufacturing facility and a single subcontractor for almost all of our subsystem module solutions could jeopardize our operations.

In June 2005, we completed the transition of our outsourced subsystem module solutions manufacturing operations from TFS to Ionics EMS, Inc. The majority of our subsystem module solutions manufacturing operations are now subcontracted to Ionics. Such operations are conducted at a single facility in Manila, Philippines.

Edgar Filing: MICROTUNE INC - Form 10-Q

Despite the transition of our manufacturing operations to Ionics, we are still exposed to manufacturing risks as a result of our dependence on a single manufacturing facility and a single sub-contractor for our subsystem module solutions. Such risks include lack of control over delivery schedules, manufacturing yields, quality and fabrication costs and the risk of material supply disruptions due to labor disputes, terrorism, political unrest, war, process abnormalities, human error, theft, government intervention, or a natural disaster such as a fire, earthquake, or flood. If we encounter any significant delays or disruptions, including those caused by our subcontractor's inability to procure component parts or supply us with product, we may not be able to meet our manufacturing and testing requirements, which could cause a significant delay in our ability to

Table of Contents

deliver our products, resulting in losses and potential enforcement of contractual line down clauses by customers, subjecting us to high litigation costs and settlement payments. Additionally, our subcontractor could elect to close its production facility or require us to move to another production facility or subcontractor. Any resulting delay could result in increased expense and costs and could have a material adverse effect on our business and results of operations.

We depend on third-party wafer subcontractors to manufacture all of our integrated circuit products, which reduces our control over the integrated circuit manufacturing process and could increase costs and decrease the availability of our integrated circuit products.

We do not own or operate a semiconductor fabrication facility. We primarily rely on IBM and X-FAB, outside subcontractors, to produce most of our RF integrated circuit products. Our reliance on third-party suppliers involves risks such as reduced control over delivery schedules, quality assurance and fabrication costs and the risk of material supply disruptions. We do not have a long-term supply agreement with our subcontractors and instead obtain manufacturing services on a purchase order basis. Our subcontractors have no obligation to supply products to us for any specific period, in any specific quantity or at any specific price, except as set forth in a particular purchase order. Our requirements represent a small portion of the total production capacity of these subcontractors, and they may reallocate capacity to other customers even during periods of high demand for our integrated circuits. If our subcontractors were unable or unwilling to continue manufacturing our integrated circuits, our business would be materially adversely affected. In such an event, we would be required to identify and qualify substitute subcontractors, which would be time consuming and difficult, and may result in unforeseen manufacturing and operational problems. In addition, if competition for foundry capacity increases, our product costs may increase, and we may be required to pay significant amounts to secure access to manufacturing services. If we do not qualify or receive supplies from additional subcontractors, we may be exposed to increased risk of capacity shortages due to our dependence on IBM and X-FAB. In addition, the processing of our integrated circuit products are specific to the manufacturing processes of one or the other of our two suppliers and substantial lead-time would be required to move the specific product to the other supplier, if it were possible at all. Further, our customers may limit their purchases from us unless a second manufacturing source is developed, which could impact our sales. We will begin using Jazz Semiconductor as an alternate source in the future for certain of our integrated circuit products; however, there can be no assurance that the establishment of a second manufacturing source would successfully mitigate the risks identified above.

We depend on third-party subcontractors for integrated circuit probing, packaging and testing, which reduces our control over these processes and could result in increased costs and decreased availability of our integrated circuit products.

Our integrated circuit products are probed, packaged, and/or tested by independent subcontractors, including Amkor, ASE, ISE and Criteria Labs, using facilities located in South Korea, Philippines, and Austin, Texas. We do not have long-term agreements with these subcontractors and typically obtain services from them on a purchase order basis. Furthermore, our subcontractors are dependent on certain third-party test equipment manufacturers. Our reliance on these subcontractors and on certain third-party test equipment manufacturers involves risks such as reduced control over delivery schedules, quality assurance and costs. Our reliance on Criteria Labs involves additional risk due to its recent emergence from bankruptcy proceedings. These risks could result in product shortages or increase our costs of probing, packaging and testing our products. If these subcontractors are unable or unwilling to continue to provide probing, packaging and testing services of acceptable quality, at acceptable costs and in a timely manner, it could have a material adverse effect on our business. In such an event, we would be required to identify and qualify substitute subcontractors, which could be time consuming and difficult and may result in unforeseen operational problems.

If our customers do not qualify our products or the manufacturing lines of our third-party suppliers for volume shipments, our revenue may be delayed or reduced.

Some customers will not purchase any of our products, other than limited numbers of evaluation units, prior to qualification of the manufacturing lines for the product. We may not always be able to satisfy the qualifications. Delays or failure to qualify can cause a customer to discontinue use of our products and result in a significant loss of revenue. If we change third-party suppliers, customers may require us to qualify the new supplier's facility, or a product manufactured by that facility.

Table of Contents

We believe that transitioning our silicon products to newer or better manufacturing process technologies will be important to our future competitive position. If we fail to make this transition efficiently, our competitive position could be seriously harmed.

We continually evaluate the benefits, on a product-by-product basis, of migrating to higher performance process technologies in order to produce more efficient or better integrated circuits because we believe this migration is required to remain competitive. Other companies in the industry have experienced difficulty in migrating to new process technologies and, consequently, have suffered reduced yields, delays in product deliveries and increased expense levels. We may experience similar difficulties. Moreover, we are dependent on our relationships with subcontractors to successfully migrate to newer or better processes. Our foundry suppliers may not make newer or better process technologies available to us on a timely or cost-effective basis, if at all. If our foundry suppliers do not make newer or better manufacturing process technologies available to us on a timely or cost-effective basis, or if we experience difficulties in migrating to these processes, it could have a material adverse effect on our competitive position and business prospects.

Uncertainties in our production planning process could have a material adverse effect on our business.

For many of our products, our manufacturing lead-time is greater than the delivery lead-times we quote our customers. Therefore, in many cases we routinely manufacture or purchase inventory based on estimates of customer demand for our RF products, which demand is difficult to predict. The cancellation or re-scheduling of product orders, the return of previously sold products or overproduction due to the failure of anticipated orders to materialize could result in our holding excess or obsolete inventory that could substantially harm our business, financial condition and results of operations. In addition, our inability to produce and ship RF products to our customers in a timely manner could harm our reputation and damage our relationships with our customers.

The semiconductor industry is cyclical. If there is a sustained upturn in the semiconductor market, there could be a resulting increase in demand for foundry and other subcontracted services, significantly reducing product availability and increasing our costs.

The semiconductor industry periodically experiences increased demand and production capacity constraints. An increase in demand for semiconductors could substantially increase the cost of producing our RF products, and consequently reduce our profit margins. As a result, we may experience substantial period-to-period fluctuations in future results of operations due to general semiconductor industry conditions.

Changes in the accounting treatment of share-based payments will adversely affect our results of operations.

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 and employee stock purchases related to our employee stock purchase plan. The application of SFAS No. 123(R) requires the use of an option-pricing model to determine the fair value of share-based payment awards. This determination of fair value is affected by our stock price as well as assumptions regarding a number of highly complex and subjective variables. These variables include, but are not limited to, our expected stock price volatility over the term of the awards and actual and projected employee stock option exercise behaviors. Stock-based compensation expense under SFAS No. 123(R) for the first quarter of 2006 was \$1.4 million. 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. In addition, if factors change and we employ different assumptions in the application of SFAS No. 123(R) in future periods, the compensation expense that we record under SFAS No. 123(R) may differ significantly from what we have recorded in the current period.

This change in accounting treatment will continue to have a material adverse effect on our reported results of operations and we cannot predict the effect that this adverse impact on our reported operating results will have on the trading price of our common stock. For an illustration of the effect of such a change in our recent results of operations, see Note 1 of Notes to Unaudited Consolidated Financial Statements.

Table of Contents

Our research and development efforts are critical to our business and if these efforts are unsuccessful, it will have a material adverse effect on our business and results of operations.

Any future success will depend, in large part, upon our ability to develop new RF products for existing and new markets; our ability to introduce these new products in a cost-effective and timely manner; and our ability to meet customer specifications and convince leading manufacturers to select these new products for design into their new products. Developing new products and improving our existing products requires substantial continuing investments of engineering resources. We have often encountered and continue to encounter difficulties attracting and retaining the highly sophisticated engineering personnel required to timely develop our products and meet our customers' design windows. In addition, the development of new RF products is highly complex and, from time to time, we have experienced delays in completing the development and introduction of new products. In addition, some of our new product development efforts are focused on producing silicon products utilizing architectures and technologies with which we have little or no experience, and delivering performance characteristics, such as low power consumption, at levels that we have not previously achieved. Our efforts to address the mobile TV market segment, in particular, will depend on our ability to overcome the challenges described above and upon eventual industry acceptance of our new mobile TV products, such as the MT2260 and MT2262. Some of our past research and development efforts have failed. For example, our Bluetooth products never gained wide market acceptance. Successful product development depends on a number of factors, including:

the accuracy of our prediction of emerging market requirements and evolving standards;

the acceptance of our new product designs by our customers and of our customers' products by consumers;

the availability of qualified product designers and our ability to attract and retain them; and

our ability to successfully design, develop, manufacture and integrate new components to increase our product functionality in a timely manner.

We have made significant changes in our executive management and reduced the scope and costs of our worldwide operations. Because of our reduced scope of operations and management discontinuity, our research and development efforts in our core technologies may lag behind those of our competitors, some of whom have substantially greater financial and technical resources. As a result of these factors, we may be unable to develop and introduce new RF products successfully and in a cost-effective and timely manner, and any new products we develop and offer may never achieve market acceptance. These failures would have a material adverse effect on our business, financial condition and results of operations.

Our business may be harmed if we fail to protect our proprietary technology.

We rely on a combination of patents, trademarks, copyrights, trade secret laws, confidentiality agreements and procedures and licensing arrangements to protect our intellectual property rights. We currently have patents issued and pending in the United States and in foreign countries. We intend to seek further United States and international patents on our technology. We cannot be certain that patents will be issued from any of our pending applications, that patents will be issued in all countries where our products can be sold or that any claims will be allowed from pending applications or will be of sufficient scope or strength to provide meaningful protection or commercial advantage. While we generally seek patent protection for our innovations, it is possible that some of these innovations may not be protectable. If our patents do not adequately protect our technology, our competitors may be able to offer products similar to ours. Our competitors may also be able to develop similar technology independently or design around our patents.

In addition, even when we do hold valid patents that we could potentially assert against a competitor's infringing products, it may not be practicable, effective or cost-efficient for us to enforce our intellectual property and contractual rights fully, particularly, where the initiation of a claim might harm our business relationships or risk a debilitating countersuit by a competitor with patents that read on our products.

Our competitors also may be able to design around our patents. The laws of some countries in which our products are or may be developed, manufactured or sold, including various countries in Asia, may not protect our products or intellectual property rights to the same extent as do the laws of the United States, increasing the possibility of piracy of our technology and products.

Edgar Filing: MICROTUNE INC - Form 10-Q

In addition to patent and copyright protection, we also rely on trade secrets, technical know-how and other non-patented proprietary know-how relating to our product development and manufacturing activities, which we seek to protect,

Table of Contents

in part, by confidentiality agreements with our customers, partners, suppliers and employees. We cannot be certain that our confidentiality agreements will not be breached, that we would have adequate remedies for any such breach or that trade-secrets and proprietary know-how will not otherwise become known by others. Although we intend to protect and vigorously defend our intellectual property rights, we may not be able to prevent misappropriation of our technology. Our competitors may also independently develop technologies that are substantially equivalent or superior to our technology.

Despite our efforts and procedures to protect our intellectual property through the prosecution of patents, trademarks, copyrights and trade secrets and other methods, we cannot assure you that our current intellectual property or any intellectual property we may obtain through acquisitions or by other means will be free from third-party claims which may be valid. Any third-party claims may lead to costly and time-consuming litigation, which could have a material adverse effect on our business, financial condition and results of operations.

Our efforts to protect our intellectual property may cause us to become involved in costly and lengthy litigation that could seriously harm our business and compromise our intellectual property position.

We have been involved in intellectual property litigation in the past and may become involved in intellectual property litigation in the future to protect our intellectual property or defend against allegations of infringement asserted by others. Legal proceedings could subject us to significant liability for damages or invalidate our proprietary rights either through litigation or a petition for USPTO re-examination initiated by a competitor. Any litigation, regardless of its outcome, would likely be time-consuming and expensive to resolve and would divert the time and attention of our management and technical personnel.

The expense associated with intellectual property litigation, the diversion of time and attention of our management and technical personnel from our daily operations caused by such litigation and any legal limitation placed upon our products and/or our business related to such litigation may have a material adverse effect on our business and results of operations.

Furthermore, we have initiated, and may initiate in the future, claims or litigation against third-parties for infringement of our proprietary rights or to establish their validity. Even if we successfully assert our intellectual property against a competitor in litigation, our patents may be attacked through a USPTO re-examination, which cannot be settled by the mutual agreement of the parties. Any future litigation by or against us, or one of our customers, could result in significant expense and divert the efforts of our technical personnel and management, whether or not the litigation results in a favorable determination.

Our ability to sell our RF products may be adversely affected if it is determined that we or our customers infringe on the intellectual property of a third-party or if any of our issued patents are determined to be invalid.

The electronics industry is characterized by vigorous protection and pursuit of intellectual property rights and positions, which may result in significant and often protracted and expensive litigation. Our customers may be subject to infringement claims for their products which incorporate our RF products. If any claims of infringement are made against any of our customers, our customers may seek to involve us in the litigation and demand indemnification from us. The resolution of such a claim against our customer may cause our customer to reduce or completely eliminate marketing its infringing product, which would decrease our sales of RF products to this customer. Further, if our customer were to prevail in its claim for indemnification against us, or if we were found to infringe on any other third-party intellectual property, we could be required to:

pay substantial damages and royalties on our historical and future product sales;

indemnify our customers for their legal fees and damages paid;

stop manufacturing, using and selling the infringing products;

expend significant resources to develop non-infringing technology;

Edgar Filing: MICROTUNE INC - Form 10-Q

discontinue the use of some of our processes; or

obtain licenses to the infringed intellectual property to sell or use the relevant technology, which may not be available on commercially reasonable terms, if at all.

Table of Contents

We may be unsuccessful in developing non-infringing products or obtaining licenses upon commercially reasonable terms. We may be unable to resolve these problems which could have a material adverse affect our business, financial condition and results of operations.

If we do not anticipate and adapt to evolving industry standards in the cable, digital TV and automotive markets, or if industry standards develop more slowly than we expect, our products could become obsolete and we could lose market share.

Applications and devices for cable, digital TV and automotive markets often are based on industry standards that are continuously evolving. We have often directed our development toward producing RF products that comply with these evolving standards. In some cases, the development of these standards takes longer than originally anticipated. The delayed development of a standard in our target markets has and could result in slower deployment of new technologies, which can harm our ability to sell our RF products, or frustrate the continued use of our proprietary technologies, due to the anticipation of the deployment of a standard. The continued delay in the development of these industry standards could result in fewer manufacturers purchasing our RF products in favor of continuing to use the proprietary technologies designed by our competitors. Such delayed development of industry standards and the resulting slower deployment of new technologies would result in diminished and/or delayed revenue and consequently harm our business. Additionally, our competitors may attempt to relax anticipated standards that we have expended significant research and development funds to meet, thereby eliminating any technical advantages that our products may have. Further, if new unexpected industry standards do emerge, and we have failed to accurately anticipate or design products that meet such standards, our products or our customers' products could become unmarketable or obsolete.

Our ability to adapt to changes and to anticipate future standards and the rate of adoption and acceptance of those standards is a significant factor in maintaining or improving our competitive position and prospects for growth. Our inability to anticipate the evolving standards for our RF products in the cable, digital TV and automotive markets, or to develop and introduce new products that are functionally and economically competitive into these markets, could result in diminished revenue and, consequently, harm our business, financial condition and results of operations. In addition, we may incur substantial unanticipated costs to comply with these evolving standards.

We have experienced volatility in our stock price and it may fluctuate in the future. Therefore, you may be unable to resell shares of our common stock at or above the price you paid for them.

The market price of our common stock has fluctuated in the past and may fluctuate significantly in the future. For example, during 2005, our common stock has traded at prices as low as \$3.05 and as high as \$7.11 per share. Such fluctuations may be influenced by many factors, many of which are outside of our control, including:

quarterly variations in our financial performance;

our business prospects;

the performance and prospects of our major customers;

the depth and liquidity of the market for our common stock;

investor perception of us and the industry in which we operate;

changes in earnings estimates or buy/sell recommendations by analysts;

short-term investor trading strategies;

Edgar Filing: MICROTUNE INC - Form 10-Q

recent changes in accounting rules related to the expensing of equity awards;

general financial and other market conditions; and

domestic and international economic and political conditions.

Public stock markets have experienced, and are currently experiencing, extreme price and trading volume volatility, particularly in the technology sectors of the market. This volatility has significantly affected the market prices of securities of many technology companies for reasons frequently unrelated to or disproportionately impacted by the operating performance of these companies. These broad market fluctuations may materially and adversely affect the market price of our common

Table of Contents

stock. In addition, fluctuations in our stock price and our price to earnings multiple may have made our stock attractive to momentum, hedge or day trading investors who often shift funds into and out of stocks rapidly, exacerbating price fluctuations in either direction, particularly when viewed on a quarterly basis.

Currency fluctuations related to our international operations could have a material adverse effect on our financial results.

A significant portion of our international revenue and expenses are denominated in foreign currencies, primarily the Euro, and we have experienced significant fluctuations in our financial results due to changing exchange rates rather than operational changes. For example, the foreign currency exchange gain was approximately \$0.1 million in the first quarter of 2006. We expect to continue to rely significantly on international sales and foreign subcontractors for the foreseeable future. As a result, we expect currency fluctuations to continue, and such fluctuations may significantly impact our financial results in the future. Currently, we do not engage in currency hedging activities, and in the future, we may choose to engage in currency hedging activities to reduce these fluctuations, which may or may not prove to be successful.

We may need to obtain the capital required to grow our business.

From time to time, we may find it necessary or we may choose to seek additional financing if our strategic growth plans change, or if industry or market conditions are favorable for a particular type of financing. Our capital requirements depend upon several factors, including the need to fund future acquisitions, the capital required to meet our research and development objectives, the rate of market acceptance of our products, our ability to expand our customer base, our level of expenditures for sales and marketing, the cost of product and service upgrades and other factors. If our capital requirements vary materially from those currently planned, we may require additional financing sooner than anticipated. There can be no assurance that we will be able to raise additional funds if needed. If we raise additional funds through the issuance of equity or convertible debt securities, the percentage ownership of our stockholders will be reduced. Further, if we issue equity securities, the new equity securities may have rights, preferences or privileges senior to those of existing holders of common stock. If we issue debt securities, the debt securities generally will have rights senior to those of existing holders of equity securities. If we cannot raise needed funds on acceptable terms, we may not be able to acquire strategic businesses, develop our products and services, take advantage of future opportunities or respond to competitive pressures or unanticipated requirements, any of which could have a material adverse effect on our ability to grow our business.

Our business could be disrupted if we are unable to successfully integrate any businesses, technologies, product lines or services that we may acquire in the future.

As part of our business strategy, we may review and selectively pursue potential acquisitions that could complement our current product offerings, augment our market coverage, complement our technical capabilities, or that would otherwise provide growth opportunities. While we currently have no imminent plans to pursue an acquisition, we may make strategic acquisitions or investments or enter into joint ventures or strategic alliances with other companies in the future, which may entail many risks. Specific examples of risks that could relate to such transactions include:

risks that we will be unable to successfully integrate the acquired company's personnel and businesses;

risks that we will be unable to realize anticipated synergies, economies of scale or other value associated with the transactions;

risks related to acquisition-related charges and amortization of acquired technology and other intangibles that could negatively affect our reported results of operations;

risks that such transactions will divert management's time and attention and disrupt our ongoing business;

risks that we will be unable to retain key technical and managerial personnel of the acquired company;

Edgar Filing: MICROTUNE INC - Form 10-Q

risks that we will be unable to establish and maintain uniform standards controls, procedures and policies;

risks related to unanticipated costs, capital expenditures or working capital requirements and the assumption of unknown liabilities or other unanticipated events or circumstances;

risks that the acquired company's customers will not desire to conduct business with us;

Table of Contents

risks related to strained relationships with employees, suppliers and customers resulting from the integration of new personnel; and

risks related to strained relationships with strategic partners who may compete with the acquired company.

In addition, future acquisitions or investments may require us to materially reduce our cash reserves; issue additional equity which would be dilutive to our stockholders or to incur debt. We cannot assure you that any acquisition or joint venture will be successfully integrated with our operations and the failure to avoid these or other risks associated with such acquisitions or investments could have a material adverse effect on our business, financial condition and results of operations.

Our Quality Certifications are subject to periodic re-evaluation.

Our design facility located in Ingolstadt, Germany is currently ISO-9000:2000 and ISO-14001 certified. These certifications and others are subject to recertification on a periodic basis. If we are unable to obtain any such recertification, it could have a material adverse effect on our business.

Our products are subject to certain environmental standards.

Beginning July 1, 2006, our product shipped into certain regions of the world must comply with the Restriction of Hazardous Substances Directive 2002/95/EC (RoHS) which restricts the use of hazardous substances in electrical and electronic equipment that is imported into the European Union. We currently have lead-free versions of our silicon products and we are in the process of altering our applicable subsystem module solutions to also be lead-free. If our customers are unable to re-qualify the lead-free versions of our products or our subsystem module manufacturers are unable to meet the RoHS/lead-free standards in a timely manner, it could have a material adverse effect on our business, results of operations and financial condition.

Our international operations, including our operations in Germany, Taiwan, Japan, China and Korea, the operations of our international suppliers and our overall financial results may be adversely affected by events that occur in or otherwise affect these countries.

We currently have facilities and suppliers located outside of the United States, including research and development operations in Germany and sales offices in Japan, Taiwan, China and Korea. Other than IBM, ISE and Criteria Labs, substantially all of our suppliers are located outside the United States, and substantially all of our products are manufactured outside the United States. As a result, our operations are affected by the local conditions in those countries, as well as actions taken by the governments of those countries. For example, if the Philippines government enacts restrictive laws or regulations, or increases taxes paid by manufacturing operations in that country, the cost of manufacturing our products in Manila could increase substantially, causing a decrease in our gross margins and profitability. In addition, if any country, including the United States, imposes significant import restrictions on our products, our ability to import our products into that country from our international manufacturing and packaging facilities could be diminished or eliminated. Local economic and political instability in areas in the Far East, in particular in the Philippines and Korea, where there has been political instability in the past, could result in unpleasant or intolerable conditions for workers, and ultimately could result in a shutdown of our facilities or our subcontractor's facilities.

Provisions in our charter documents, Delaware law and our stockholder rights plan may deter takeover efforts and limit the ability of our stockholders to receive a premium for their shares of our common stock.

Several provisions of our restated certificate of incorporation, Delaware law and our stockholder rights plan may discourage, delay or prevent a merger or acquisition that you may consider favorable and therefore may prevent our stockholders from receiving a premium for their shares of our common stock.

Those provisions include:

a provision authorizing the issuance of blank check preferred stock;

a provision prohibiting cumulative voting in the election of directors;

Edgar Filing: MICROTUNE INC - Form 10-Q

a provision limiting the persons who may call special meetings of the board or the stockholders;

a provision prohibiting stockholder action by written consent;

Table of Contents

a provision establishing advance notice requirements for nominations for election to the board of directors or for proposing matters that can be acted on by stockholders at stockholder meetings;

a provision establishing super-majority voting requirements in some instances; and

a provision providing rights to purchase fractional shares of preferred stock to our existing stockholders in the event of certain acquisition attempts.

On May 25, 2005, our stockholders approved certain amendments to our amended and restated certificate of incorporation and amended and restated bylaws that had the effect of declassifying our board of directors so that all of our directors must stand for election every year at our annual meeting of stockholders. The declassification of our board of directors was a requirement of our settlement of the consolidated derivative stockholder litigation.

We have been the target of several securities fraud class action complaints in the past and are at risk of future securities class action litigation. Future litigation 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. We have accepted a settlement proposal presented to all issuer defendants and are waiting for final court approval. For additional discussion of this litigation, see Note 7 of Notes to Unaudited Consolidated Financial Statements.

Class Action Litigation

Beginning in February 2003, Microtune and certain of our former executive officers were named as defendants in several class action lawsuits alleging violations of federal securities laws and regulations.

On November 23, 2004, Microtune and the other defendants entered into a settlement agreement with the plaintiffs under which the defendants agreed to settle the consolidated lawsuit for \$5.625 million, inclusive of attorneys' fees and costs, in return for a full release of all claims and dismissal of the consolidated lawsuit. On April 4, 2005, the district court entered an order of dismissal and final judgment which gave final approval to the securities class action litigation settlement. Microtune and the other defendants made no admission of wrongdoing as part of the settlement.

Stockholder Derivative Litigation

Beginning on October 30, 2003, various stockholder derivative lawsuits were filed against current and former officers and directors of Microtune, alleging various breaches of fiduciary duties, abuse of control, and waste of corporate assets.

On January 10, 2005, Microtune and the other defendants entered into a settlement agreement with the plaintiffs to settle the derivative litigation. Under the terms of the agreement, Microtune agreed to pay the plaintiffs' attorneys' fees and expenses in an amount not to exceed \$1.125 million and further agreed to adopt certain changes to its corporate governance policies in exchange for a full release of all claims and dismissal of the derivative litigation. On March 31, 2005, the district court entered an order of dismissal and final judgment which gave final approval to the stockholder derivative litigation settlement. Microtune and the other defendants made no admission of wrongdoing as part of the settlement.

There is no guarantee our insurance coverage, including our directors' and officers' liability insurance, will be sufficient to cover any eventual liability and any shortfall in insurance coverage would impact our cash position which could have a material adverse effect on our financial condition.

We purchase various insurance policies to cover specifically designated risks in varying amounts. There is no guarantee that when a claim arises under any of the covered risks that our coverage will be sufficient to cover the entire claim or that any specific claim will be covered, even in part, by insurance. Furthermore, directors' and officers' liability insurance may not be available to us in sufficient amounts to cover any claims made or defense costs incurred if securities litigation is filed against us in the future. These factors may result in rapid and substantial depletion of our cash reserves, and this depletion may result in our inability to properly operate our business and could have a material adverse effect on

our financial condition.

Table of Contents

Investor confidence and share value may be adversely affected if we are unable to file all required reports with the Securities and Exchange Commission in a timely manner.

Our ability to file in a timely manner with the Securities and Exchange Commission the reports required pursuant to the Securities Exchange Act of 1934, as amended, including quarterly reports on Form 10-Q and annual reports on Form 10-K, could be adversely affected by the following events:

loss of key management or finance and accounting personnel;

technical issues with our enterprise resource planning software or other financial reporting tools;

delays in the review of our quarterly results or audit of our annual results by our outside auditors;

unexpected change of our independent audit firm;

significant acquisitions or mergers;

disposition of a portion of our business; and

acts of God or force majeure.

Any delay in filing any such report could result in a loss of investor confidence in the reliability of our financial statements and an adverse reaction in the financial marketplace, which ultimately could adversely impact the market price of our shares. Additionally, this could result in the delisting of our stock from The NASDAQ National Market and subsequent quoting of our stock on the pink sheets, hindering liquidity of our stock and increasing trading costs and fees for investors.

If we or our independent registered public accounting firm are unable to provide adequate attestation regarding the adequacy of our internal controls over financial reporting, as required by Section 404 of the Sarbanes-Oxley Act of 2002, it may have a material adverse effect on investor confidence and the market value of our common stock.

The Securities and Exchange Commission, as directed by Section 404 of the Sarbanes-Oxley Act of 2002, has adopted rules requiring public companies to include a report of management on the company's internal controls over financial reporting in its annual reports on Form 10-K that contains an assessment by management of the effectiveness of the company's internal controls over financial reporting. In addition, the company's independent registered public accounting firm must attest to and report on management's assessment of the effectiveness of the company's internal controls over financial reporting. This requirement will continue to apply to our future Annual Reports on Form 10-K. We have a complex business organization that is international in scope. Ensuring that we have adequate internal financial and accounting controls and procedures in place to help ensure that we can produce accurate financial statements on a timely basis is a costly and time-consuming effort that needs to be reevaluated frequently. Although we intend to diligently and vigorously review our internal controls over financial reporting in order to ensure compliance with the Section 404 requirements, there can be no assurance that we will be successful in future years. Further, if our independent registered public accounting firm is not satisfied with our internal controls over financial reporting or the level at which these controls are documented, designed, operated or reviewed, or if the independent registered public accounting firm interprets the requirements, rules or regulations differently from us, then they may decline to attest to management's assessment or may issue a report that is qualified. This could result in an adverse reaction in the financial marketplace due to a loss of investor confidence in the reliability of our financial statements, which ultimately could negatively impact the market price of our shares. Additionally, this could result in the delisting of our stock from The NASDAQ National Market and subsequent quoting of our stock on the pink sheets, hindering liquidity of our stock and increasing trading fees to investors.

Table of Contents

ITEM 6. EXHIBITS

Exhibit

Number

- | | |
|--------------------|---|
| 3.1 ⁽¹⁾ | Restated Certificate of Incorporation filed with the Secretary of State of the State of Delaware on May 25, 2005. |
| 3.2 ⁽¹⁾ | Third Amended and Restated Bylaws, as amended April 13, 2005. |
| 10.1 | General Managing Contract between Microtune GmbH & Co. KG and Mr. Barry F. Koch, dated effective May 17, 2000. |
| 31.1 | Certification of Chief Executive Officer under Section 302 of the Sarbanes-Oxley Act of 2002. |
| 31.2 | Certification of Principal 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 Principal Financial Officer under Section 906 of the Sarbanes-Oxley Act of 2002. |
-

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

Table of Contents

SIGNATURE

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

MICROTUNE, INC.

By: **/s/ JEFFREY A. KUPP**
Jeffrey A. Kupp

Chief Financial Officer

(Principal Financial Officer and Principal

Accounting Officer)

Date: April 28, 2006