MONOLITHIC POWER SYSTEMS INC
Form 10-Q
October 23, 2008
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended September 30, 2008

OR

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
Commission file number: 000-51026

Monolithic Power Systems, Inc.

(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

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

6409 Guadalupe Mines Road, San Jose, CA 95120 (408) 826-0600

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

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

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

Large accelerated filer ¨	Accelerated filer x
Non-accelerated filer ¨ (Do not check if a smaller reporting company)	Smaller Reporting Company ¨

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

There were 33,739,230 shares of the registrant s common stock issued and outstanding as of October 15, 2008.

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MONOLITHIC POWER SYSTEMS, INC.

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EXPLANATORY NOTE

We are amending the unaudited condensed financial information for the three and nine months ended September 30, 2007 contained in this Quarterly Report on Form 10-Q to amend and restate our condensed consolidated financial statements for such periods, and the related notes thereto, as discussed in Note 10 in our Notes to Condensed Consolidated Financial Statements contained under *Item 1: Financial Statements* in this Quarterly Report on Form 10-Q.

On April 28, 2008, the Audit Committee of our Board of Directors determined that our previously issued financial statements for the years ended December 31, 2006 and 2007 contained a material error thus requiring the restatement of such financial statements. On May 12, 2008, we filed an Amendment No. 1 to our Annual Report on Form 10-K/A for the year ended December 31, 2007, to amend and restate our consolidated financial statements as of December 31, 2007 and 2006 and for the years ended December 31, 2007 and 2006 with respect to errors in the accounting for the tax effect of stock-based compensation related to Monolithic Power Systems, Inc. s cost-share agreement with a foreign subsidiary.

The effects of these restatements are reflected in the condensed consolidated financial statements for the three and nine months ended September 30, 2007 included in this Quarterly Report on Form 10-Q. Therefore, we have not amended and do not intend to amend any of our previously filed Quarterly Reports on Form 10-Q for any period prior to December 31, 2007.

The following sections in this report have been amended from the Company s Quarterly Report on Form 10-Q for the three and nine months ended September 30, 2007 filed on November 1, 2007 as a result of the matters described above:

Part I:

Item 1 Financial Statements
Item 2 Management s Discussion and Analysis of Financial Condition and Results of Operations

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

MONOLITHIC POWER SYSTEMS, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands, except par value and share amounts)

(Unaudited)

	September 30, 2008	December 31, 2007
ASSETS		
Current assets:		
Cash and cash equivalents	$ 75,917	$ 83,114
Short-term investments	8,711	27,765
Accounts receivable, net of allowances of $0 in 2008 and $227 in 2007	18,781	8,239
Inventories	22,305	17,487
Deferred income tax asset current	76	72
Prepaid expenses and other current assets	3,840	4,733
Restricted assets	13,512	7,350
Total current assets	143,142	148,760
Property and equipment, net	14,474	14,175
Long-term investments	36,825	
Deferred income tax asset long term	776	776
Other assets	598	539
Restricted assets	7	8,340
Total assets	$ 195,822	$ 172,590
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 8,155	$ 6,154
Accrued compensation and related benefits	6,377	8,299
Accrued liabilities	14,150	14,959
Total current liabilities	28,682	29,412
Deferred rent and other liabilities	38	323
Non-current income tax liability	5,316	5,318
Total liabilities	34,036	35,053
Stockholders equity:		
Common stock, $0.001 par value, $34 and $33 in 2008 and 2007, respectively; shares authorized:	148,353	143,890
150,000,000; shares issued and outstanding: 33,927,788 and 33,454,595 in 2008 and 2007,		

respectively		
Deferred stock compensation		(3)
Retained earnings (accumulated deficit)	14,178	(6,815)
Accumulated other comprehensive income (loss)	(745)	465
Total stockholders equity	161,786	137,537
Total liabilities and stockholders equity	$ 195,822	$ 172,590

See accompanying notes to condensed consolidated financial statements.

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MONOLITHIC POWER SYSTEMS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share amounts)

(Unaudited)

	Three months ended		Nine months ended	
	September 30, 2008	September 30, 2007 (as restated, see Note 10)	September 30, 2008	September 30, 2007 (as restated, see Note 10)
Revenue	$ 48,891	$ 40,188	$ 125,802	$ 95,517
Cost of revenue*	18,201	14,662	46,620	34,873
Gross profit	30,690	25,526	79,182	60,644
Operating expenses:				
Research and development*	9,420	7,489	25,594	19,849
Selling, general and administrative*	9,560	8,071	27,200	21,387
Lease abandonment				(496)
Patent litigation settlement				9,800
Provision for litigation expense	1,090	1,452	6,120	8,327
Total operating expenses	20,070	17,012	58,914	58,867
Income from operations	10,620	8,514	20,268	1,777
Other income (expense):				
Interest and other income	684	1,223	2,928	3,399
Interest and other expense	(389)	8	(507)	(21)
Total other income, net	295	1,231	2,421	3,378
Income before income taxes	10,915	9,745	22,689	5,155
Income tax provision	458	752	1,697	2,857
Net income	$ 10,457	$ 8,993	$ 20,992	$ 2,298
Basic net income per share	$ 0.31	$ 0.28	$ 0.63	$ 0.07
Diluted net income per share	$ 0.29	$ 0.25	$ 0.58	$ 0.07
Weighted average common shares outstanding	33,869	31,995	33,482	31,293
Stock options and restricted stock	2,733	3,958	2,850	3,697
Diluted weighted-average common equivalent shares outstanding	36,602	35,953	36,332	34,990
* Stock-based compensation has been included in the				
following line items:				
Cost of revenue	$ 76	$ 149	$ 249	$ 373
Research and development	1,471	1,326	4,074	3,379

Selling, general and administrative	1,787	1,748	5,141	4,296
Total	$ 3,334	$ 3,223	$ 9,464	$ 8,048

See accompanying notes to condensed consolidated financial statements.

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MONOLITHIC POWER SYSTEMS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(Unaudited)

	Nine months ended September 30,	
	2008	2007 (as restated, See Note 10)
Cash flows from operating activities:		
Net income	$ 20,992	$ 2,298
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	4,211	2,962
Loss on disposal of property and equipment	4	99
Deferred income tax assets		2,025
Deferred income tax liabilities		(39)
Tax benefit from stock option transactions	1,833	3,096
Excess tax benefit from stock option transactions	(583)	(2,417)
Stock-based compensation	9,464	8,048
Changes in operating assets and liabilities:		
Accounts receivable	(10,541)	(3,616)
Inventories	(4,776)	(9,097)
Prepaid expenses and other assets	817	(3,313)
Accounts payable	1,732	3,620
Accrued and other long-term liabilities	(889)	5,369
Accrued income taxes payable and noncurrent tax liabilities	(1,253)	1,812
Accrued compensation and related benefits	(1,953)	2,077
Deferred rent	(196)	(160)
Net cash provided by operating activities	18,862	12,764
Cash flows from investing activities:		
Property and equipment purchases	(3,623)	(4,647)
Proceeds from sale of property and equipment		27
Purchase of short-term investments	(17,370)	(53,733)
Purchase of long-term investments	(28,050)	
Proceeds from sale of short-term investments	24,910	57,024
Proceeds from sale of long-term investments	725	
Changes in restricted assets	2,296	
Net cash used in investing activities	(21,112)	(1,329)
Cash flows from financing activities:		
Proceeds from issuance of common stock	14,405	12,680
Repurchase of common stock	(20,022)	
Excess tax benefits from stock option transactions	583	2,417
Net cash provided by (used in) financing activities	(5,034)	15,097
Effect of change in exchange rates on cash	87	60
Net increase (decrease) in cash and cash equivalents	**(7,197)**	**26,592**

Cash and cash equivalents, beginning of period		83,114		50,816
Cash and cash equivalents, end of period	$	75,917	$	77,408
Supplemental disclosures of cash flow information:				
Cash paid (refund) for taxes	$	472	$	(1,285)
Supplemental disclosures of non-cash investing and financing activities:				
Liability accrued for equipment purchases	$	241	$	864
Unrealized loss on available-for-sale investments	$	2,000	$	

See accompanying notes to condensed consolidated financial statements.

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MONOLITHIC POWER SYSTEMS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. ***Basis of Presentation*** The accompanying unaudited condensed consolidated financial statements have been prepared by Monolithic Power Systems, Inc. (the Company or MPS) in accordance with the rules and regulations of the Securities and Exchange Commission (the SEC). Certain information and disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted in accordance with these rules and regulations. The information in this report should be read in conjunction with the Company s audited consolidated financial statements and notes thereto included in its Form 10-K/A filed with the SEC on May 12, 2008.

In the opinion of management, the accompanying unaudited condensed consolidated financial statements reflect all adjustments (consisting only of normal recurring adjustments) necessary to present fairly the Company s financial position, results of operations and cash flows for the interim periods presented. The financial statements contained in this Form 10-Q are not necessarily indicative of the results that may be expected for the year ending December 31, 2008 or for any other future period.

Recent Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 157 (SFAS 157), *Fair Value Measurements*. SFAS 157 defines fair value to measure assets and liabilities, establishes a framework for measuring fair value, and requires additional disclosures about the use of fair value. SFAS 157 is applicable whenever another accounting pronouncement requires or permits assets and liabilities to be measured at fair value. SFAS 157 does not expand or require any new fair value measures. In February 2008, the FASB issued FASB Staff Position (FSP) SFAS 157-2, *Effective Date of FASB Statement No. 157* which delays the effective date of SFAS No. 157 from 2008 to 2009 for all non-financial assets and non-financial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). The Company adopted SFAS 157 on January 1, 2008. The impact of the adoption of SFAS 157 on the Company s consolidated financial statements is discussed in Note 9. The Company is currently evaluating the impact of adoption of SFAS 157 as it relates to their nonfinancial assets and nonfinancial liabilities.

In February 2007, the FASB issued SFAS No. 159 (SFAS 159), *The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115*. SFAS 159 expands the use of fair value accounting but does not affect existing standards which require assets or liabilities to be carried at fair value. The objective of SFAS 159 is to improve financial reporting by providing companies with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. Under SFAS 159, a company may elect to use fair value to measure eligible items at specified election dates and report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. Eligible items include, but are not limited to, accounts and loans receivable, available-for-sale and held-to-maturity securities, equity method investments, accounts payable, guarantees, issued debt and firm commitments. The Company adopted SFAS 159 on January 1, 2008 and did not elect the fair value measurement option for any of its financial assets or liabilities.

In May 2008, the FASB issued SFAS No. 162 (SFAS 162), *The Hierarchy of Generally Accepted Accounting Principals.* SFAS 162 identifies the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles (GAAP) in the United States. This Statement is effective 60 days following the SEC s approval of the Public Company Accounting Oversight Board amendments to AU Section 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles.* The Company is currently evaluating the potential impact, if any, the adoption of SFAS 162 will have on its consolidated financial statements.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Continued) (Unaudited)

2. ***Stock-Based Compensation*** The Company has two stock option plans and an employee stock purchase plan the 1998 Stock Option Plan, the 2004 Equity Incentive Plan and the 2004 Employee Stock Purchase Plan. The Company recognized stock-based compensation expenses for the three and nine months ended September 30, 2008 and 2007, as follows (in thousands):

	Three months ended September 30,		Nine months ended September 30,	
	2008	2007	2008	2007
Non-Employee	$ 15	$ 72	$ 43	$ 118
ESPP	160	154	480	448
Restricted Stock	801	516	2,162	1,214
Stock Options	2,358	2,481	6,779	6,268
TOTAL	$ 3,334	$ 3,223	$ 9,464	$ 8,048

Stock Options

1998 Stock Option Plan

Under the Company s 1998 Stock Option Plan (the 1998 Plan), the Company reserved 11,807,024 shares of common stock for issuance to the Company s employees, directors and consultants. Options granted under the 1998 Plan have a maximum term of ten years and generally vest over four years at the rate of 25 percent one year from the date of grant and 1/48th monthly thereafter. On November 19, 2004, the effective date of the Company s initial public offering, the 1998 Plan was terminated for future grants and the remaining 1,392,750 shares available for grant were moved to the Company s 2004 Equity Incentive Plan (the 2004 Plan). In addition, throughout the year, shares underlying options from the 1998 Plan that are cancelled (for example, upon termination of service) are transferred to the 2004 Plan based on the number of cancellations that occur throughout the year.

2004 Equity Incentive Plan

The Company s Board of Directors adopted the Company s 2004 Equity Incentive Plan in March 2004, and the Company s stockholders approved it in November 2004. Options granted under the 2004 Plan have a maximum term of ten years. New hire grants generally vest over four years at the rate of 25 percent one year from the date of grant and 1/48 th monthly thereafter. Refresh grants generally vest over four years at the rate of 50 percent two years from the date of grant and 1/48th monthly thereafter. There were 800,000 shares initially reserved for issuance under the 2004 Plan. The 2004 Plan provides for annual increases in the number of shares available for issuance beginning on January 1, 2005 equal to the least of: 5% of the outstanding shares of common stock on the first day of the year, 2,400,000 shares, or a number of shares determined by the Board of Directors. The following is a summary of the 2004 Plan, which includes stock options and restricted stock awards and units:

Available for Grant as of December 31, 2007	1,603,319
2008 Additions to Plan	1,672,730
2008 Grants	(1,618,417)
2008 Cancellations	355,977
Available for Grant as of September 30, 2008	2,013,609

A summary of the status of the Company s stock option plans at September 30, 2008 and changes during the nine months then ended is presented in the table below:

	Stock Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value
Outstanding at December 31, 2007	7,442,806	$ 10.50	6.64	$ 81,762,963
Options granted (weighted-average fair value of $7.11 per share)	1,318,290	19.59		
Options exercised	(1,403,102)	9.00		
Options forfeited	(336,132)	14.14		
Outstanding at September 30, 2008	7,021,862	$ 12.33	5.98	$ 40,866,783
Options exercisable at September 30, 2008 and expected to become exercisable	6,462,240	$ 11.99	5.95	$ 39,536,100
Options vested and exercisable at September 30, 2008	3,404,530	$ 7.82	5.72	$ 32,758,504

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Continued) (Unaudited)

The total intrinsic value of options exercised during the three months ended September 30, 2008 and 2007 was $7.3 million and $11.5 million, respectively. The total intrinsic value of options exercised during the nine months ended September 30, 2008 and 2007 was $20.4 million and $26.6 million, respectively. Net cash proceeds from the exercise of stock options was $4.8 million for the three months ended September 30, 2008 and $5.4 million for the three months ended September 30, 2007. Net cash proceeds from the exercise of stock options was $12.6 million for the nine months ended September 30, 2008 and $11.0 million for the nine months ended September 30, 2007. At September 30, 2008, unamortized compensation expense related to unvested options was approximately $18.4 million. The weighted average period over which compensation expense related to these options will be recognized is approximately 2.5 years.

The employee stock-based compensation expense recognized under SFAS 123(R) was determined using the Black-Scholes option pricing model. Option pricing models require the input of subjective assumptions and these assumptions can vary over time. The Company used the following weighted-average assumptions to determine the fair values of stock based awards granted during the three and nine months ended September 30, 2008 and 2007:

	Three months ended September 30,		Nine months ended September 30,	
	2008	2007	2008	2007
Expected term (years)	4.1	4.4	4.2	4.5
Expected volatility	40.2%	42.8%	40.4%	45.3%
Risk-free interest rate	3.1%	4.6%	2.8%	4.7%
Dividend yield				

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

2004 Employee Stock Purchase Plan

Under the 2004 Employee Stock Purchase Plan (the Purchase Plan), eligible employees may purchase common stock through payroll deductions. Participants may not purchase more than 2,000 shares in a six-month offering period or stock having a value greater than $25,000 in any calendar year as measured at the beginning of the offering period in accordance with the Internal Revenue Code and applicable Treasury Regulations. A total of 200,000 shares of common stock were reserved for issuance under the Purchase Plan. The Purchase Plan provides for an automatic annual increase beginning on January 1, 2005 by an amount equal to the least of 1,000,000 shares; 2% of the outstanding shares of common stock on the first day of the year; or a number of shares as determined by the Board of Directors. For the three months ended September 30, 2008 and 2007, 65,117 shares and 71,465 shares, respectively, were issued under the Purchase Plan. For the nine months ended September 30, 2008 and 2007, 125,207 shares and 180,148 shares, respectively, were issued under the Purchase Plan. The following is a summary of the Purchase Plan and changes during the nine months ended September 30, 2008:

Available Shares as of December 31, 2007	1,497,217
2008 Additions to Plan	669,092
2008 Purchases	(125,207)
Available Shares as of September 30, 2008	2,041,102

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Continued) (Unaudited)

The Purchase Plan is considered compensatory under SFAS 123(R) and is accounted for in accordance with FASB Technical Bulletin 97-1 (FTB 97-1) *Accounting under Statement 123 for Certain Employee Stock Purchase Plans with a Look-Back Option*. The intrinsic value for stock purchased was $0.7 million and $0.8 million for the three and nine months ended September 30, 2008, respectively, and $0.5 million and $1.2 million for the three and nine months ended September 30, 2007, respectively. The unamortized expense as of September 30, 2008 was $0.3 million, which will be recognized over 0.4 years. The Black-Scholes option pricing model was used to value the employee stock purchase rights. For the three and nine months ended September 30, 2008 and 2007, the following assumptions were used in the valuation of the stock purchase rights:

	Three months ended September 30,		Nine months ended September 30,	
	2008	2007	2008	2007
Expected term (years)	0.5	0.5	0.5	0.5
Expected volatility	45.4%	38.9%	48.3%	45.2%
Risk-free interest rate	1.9%	5.1%	2.0%	5.1%
Dividend yield				

Restricted Stock

A portion of the Company s shares of common stock were issued under restricted stock purchase agreements. Under these agreements, in the event of a termination of an employee, the Company has the right to repurchase the common stock at the original issuance price of $0.001. The repurchase right expires over a 48 month period. A summary of the Company s restricted stock awards is presented in the table below:

	Restricted Stock Awards	Weighted Average Grant Date Fair Value	Weighted Average Remaining Recognition Period (Years)
Outstanding at December 31, 2007	175,539	$ 10.86	1.31
Awards released	(76,076)	10.18	
Awards forfeited	(16,586)	9.62	
Outstanding at September 30, 2008	82,877	$ 11.72	0.77

The Company also grants restricted stock units, which vest generally over two to four years as determined by the Company s Compensation Committee, and are issued upon vesting. A summary of the restricted stock units is presented in the table below:

	Restricted Stock Units	Weighted Average Grant Date Fair Value	Weighted Average Remaining Recognition Period (Years)
Granted as of December 31, 2007	182,500	$ 15.37	1.91
Awards granted	300,127	18.69	
Awards released	(57,875)	16.53	
Awards forfeited	(7,609)	15.98	
Granted as of September 30, 2008	417,143	$ 17.84	2.71

The intrinsic value related to restricted stock awards and units released for the three months ended September 30, 2008 and 2007 was $1.4 million and $0.5 million, respectively. The intrinsic value related to restricted stock awards and units released for the nine months ended September 30, 2008 and 2007 was $2.7 million and $1.4 million, respectively. At September 30, 2008, the unamortized compensation expense related to unvested restricted stock awards and units was approximately $5.8 million with a weighted average remaining recognition period of 2.4 years.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Continued) (Unaudited)

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

	September 30, 2008	December 31, 2007
Work in progress	$ 14,857	$ 8,101
Finished goods	7,448	9,386
Total inventories	$ 22,305	$ 17,487

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

	September 30, 2008	December 31, 2007
Warranty	$ 815	$ 1,025
Legal expenses and settlement costs	8,575	9,664
Professional fees	645	746
Deferred revenue	1,437	1,306
Other	2,678	2,218
Total accrued liabilities	$ 14,150	$ 14,959

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

For the three and nine months ended September 30, 2008 and 2007, the Company had securities outstanding that could potentially dilute basic earnings per share in the future, but were excluded from the computation of diluted net income per share in the periods presented as their effect would have been antidilutive. The shares of common stock issuable upon conversion or exercise of such outstanding securities consist of the following:

	Three months ended September 30,		Nine months ended September 30,	
	2008	2007	2008	2007
Stock Options	1,661	23	1,854	1,047
Total	1,661	23	1,854	1,047

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Continued) (Unaudited)

For the three and nine months ended September 30, 2008 and 2007, the Company s comprehensive income includes foreign currency translation adjustments. For the three and nine months ended September 30, 2008, the Company s comprehensive income also includes a temporary impairment (unrealized loss) of $1.6 and $2.0 million, respectively, from long-term investments. The following table sets forth the components of other comprehensive income, net of income tax effect (in thousands):

	Three months ended September 30,		Nine months ended September 30,	
	2008	2007	2008	2007
Net income	$ 10,457	$ 8,993	$ 20,992	$ 2,298
Other comprehensive income:				
Unrealized loss on available-for-sale and long-term investments	(1,642)		(2,053)	
Foreign currency translation adjustments	(79)	169	843	308
Comprehensive income	$ 8,736	$ 9,162	$ 19,782	$ 2,606

6. ***Segment Information***

As defined by the requirements of SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*, the Company operates in one reportable segment: the design, development, marketing and sale of high-performance, mixed-signal analog semiconductors for the computing, consumer electronics, and wireless markets. Geographic revenue is based on the location to which customer shipments are delivered. For the three and nine months ended September 30, 2008, the Company derived substantially all of its revenue from sales to customers located outside North America. The following is a list of customers whose sales exceeded 10% of revenue for the three and nine months ended September 30, 2008 and 2007:

	Three months ended September 30,		Nine months ended September 30,	
Customers	2008	2007	2008	2007
A	18%	18%	20%	18%
B	14%	*	10%	*
C	10%	17%	10%	15%

* represents less than 10%

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

	Three months ended September 30,		Nine months ended September 30,	
Country	2008	2007	2008	2007
China	$ 20,556	$ 20,766	$ 56,529	$ 48,190
Korea	8,963	4,245	20,903	11,301
Taiwan	7,990	5,218	17,656	14,048
Japan	4,612	3,453	12,356	8,182
Europe	3,125	3,139	8,593	6,118
Other	2,508	2,189	6,541	5,008
USA	1,137	1,178	3,224	2,670

Total	$ 48,891	$ 40,188	$ 125,802	$ 95,517

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

	Three months ended September 30,		Nine months ended September 30,	
Product Family	**2008**	**2007**	**2008**	**2007**
DC to DC Converters	$ 34,131	$ 25,590	$ 88,113	$ 61,448
LCD Backlight Inverters	10,335	10,940	27,064	25,991
Audio Amplifiers	4,425	3,658	10,625	8,078
Total	$ 48,891	$ 40,188	$ 125,802	$ 95,517

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Continued) (Unaudited)

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

	September 30, 2008	December 31, 2007
China	$ 10,420	$ 10,598
United States	4,060	3,635
Taiwan	106	105
Japan	28	26
Other	40	55
TOTAL	$ 14,654	$ 14,419

7. ***Litigation***

O2 Micro, Inc.

Since November 2000, the Company has been engaged in multiple legal proceedings involving patent infringement claims with O2 Micro, Inc. and its parent corporation, O2 Micro International Limited (referred to hereinafter as O2). All of these claims relate to the Company s cold cathode fluorescent lighting (CCFL) backlight inverter products, which are part of its LCD backlight inverter family.

In the United States District Court for the Northern District of California, O2 alleged that certain of the Company s CCFL products infringe O2 s 722 patent. On October 30, 2007, the Court entered judgment that all of the 722 patent claims asserted by O2 against the Company are invalid and denied all post-trial motions. Subsequently, O2 filed an appeal and the Company filed a cross-appeal, with the Federal Circuit. The appeals are currently pending.

On May 1, 2007, the Company filed for declaratory judgment relief in the United States District Court for the Northern District of California against O2 that certain of the Company s CCFL products do not infringe O2 s 129 patent and that the 129 patent is invalid and unenforceable. On August 20, 2008, the parties filed a joint stipulation to a dismissal with prejudice of their respective claims for relief in which O2 covenants not to assert or reassert its 129 patent against the Company or its direct and indirect customers for infringement by the Company s series of power inverter controller products.

On September 30, 2008, based on information and belief that O2 had alleged to the Company s customer that certain of its inverter controller products infringe O2 s patents, the Company filed for declaratory judgment relief in the United States District Court for the Northern District of California against O2 that those products do not infringe O2 s 6,856,519 (519) patent family. This case is still in the early proceedings.

In addition to the U.S. litigation described above, O2 has brought various legal proceedings against the Company in Taiwan based upon a Taiwan patent. The Company previously posted cash bonds of approximately $7.9 million with the Taiwan Courts in support of its counter-injunctions and to prevent O2 from seizing the Company s assets. In July 2008, the parties agreed to cease all provisional remedial disputes against each other and allow the parties to retrieve the bonds posted. As a result of the agreement, the Company retrieved a portion of the bonds in the amount of approximately $1.8 million in the third quarter of 2008 and the remaining portion in October 2008. The remaining $6.1 million is currently recorded as short-term restricted assets on the Company s consolidated balance sheet as of September 30, 2008.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Continued) (Unaudited)

Taiwan Sumida Electronics

On July 30, 2007, the Company settled its litigation with TSE concerning the Indemnification Agreement. As of September 30, 2008, the Company had $7.4 million held in escrow for which the Company could be liable subject to the outcome of certain legal activities which are still pending in front of the Federal Circuit Court of Appeal.

Linear Technology Corporation

On July 1, 2008, the United States District Court for the District of Delaware issued a judgment as a matter of law that the Company did not breach its October 1, 2005 Settlement and License Agreement with Linear. The Company plans to seek recovery of its attorney fees and costs from Linear, pursuant to a prevailing party attorneys fees provision in the Settlement and License Agreement. However, there can be no assurance that the Company can be successful in obtaining such recovery.

The court also found as a matter of law that the Company did not willfully infringe the patent claims of U.S. Patent Numbers 5,481,178 and 6,580,258 asserted by Linear against MPS accused MP1543 product, which has been discontinued. However, the jury returned a verdict that an evaluation board containing the previously discontinued MP1543 product had directly infringed the asserted patent claims and that Linear s patents mentioned above are valid. The parties had stipulated to a total of ten dollars in nominal patent infringement damages in the event that Linear prevailed in that dispute. The court has not issued a final judgment concerning the patent infringement and validity claims.

Chip Advanced Technology Inc.

On December 12, 2007, the Company filed a patent infringement lawsuit in the U.S. District Court for the Central District of California against Chip Advanced Technology Inc. (CAT), asserting that CAT willfully infringed a MPS patent that enables efficient low voltage, low current power conversions, such as DC-DC step down converters. In the complaint, MPS seeks unspecified damages and a court-ordered injunction against future infringement by CAT. Through this lawsuit, MPS intends to vigorously protect and enforce its intellectual property. On September 16, 2008, the Company amended its complaint to add trade secret misappropriation claims against CAT. As the case is in its early stages, the Company is not able to determine the outcome of the litigation.

8. ***Stock Repurchase Program***

On February 5, 2008, the Company announced that its Board of Directors approved a stock repurchase program that authorizes the Company to repurchase up to $25.0 million of its common stock through the end of 2008. As of September 30, 2008, the following shares have been repurchased through the open market and subsequently retired:

2008 Calendar Year	Shares Repurchased	Average Price per Share	Value (in thousands)
February	27,500	$ 16.88	$ 464
March	527,332	$ 17.12	$ 9,028
April	201,863	$ 20.03	$ 4,043
May	100	$ 21.98	$ 2
June	18,000	$ 21.66	$ 390
July	14,155	$ 21.86	$ 309
August	100	$ 22.03	$ 2
September	307,355	$ 18.82	$ 5,784
Total	1,096,405		$ 20,022

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Continued) (Unaudited)

9. ***Fair Value Measurements***

The Company adopted the provisions of SFAS No. 157, *Fair Value Measurements,* effective January 1, 2008. This Statement defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles in the United States of America, and requires that assets and liabilities carried at fair value be classified and disclosed in one of the three categories noted below. The following table details the fair value measurements as of September 30, 2008 within the fair value hierarchy of the financial assets that are required to be recorded at fair value (in thousands):

		Fair Value Measurements at Reporting Date Using		
	Total	Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3
Cash and cash equivalents	$ 61,935	$ 61,935	$	$
Fixed income available-for-sale securities	22,693	22,693		
Auction-rate securities	36,825			36,825
	$ 121,453	$ 84,628	$	$ 36,825

Fixed income available-for-sale securities includes government agencies and treasuries and commercial paper, $8.7 million of which are classified as short-term investments and the remainder of which is classified as cash and cash equivalents on the Consolidated Balance Sheet. At September 30, 2008, there was an immaterial amount of unrealized gains and losses from these investments.

The following table provides a reconciliation of the beginning and ending balances for the assets measured at fair value using significant unobservable inputs (Level 3) (in thousands):

Beginning balances as of January 1, 2008	$
Unrealized loss included in accumulated other comprehensive loss	$ (410)
Purchases, sales and settlements (net)	$ 28,050
Transfer into Level 3	$ 11,500
Ending balances as of March 31, 2008	$ 39,140
Ending balances as of June 30, 2008	$ 39,140
Unrealized loss included in accumulated other comprehensive loss	$ (1,590)
Purchases, sales and settlements (net)	$ (725)
Ending balances as of September 30, 2008	$ 36,825

The Company s Level 3 assets consist entirely of auction-rate securities. The market for auction-rate securities, which are generally issued by municipalities with interest rates that reset through a Dutch auction every 7 to 35 days, became illiquid earlier in 2008. As of September 30, 2008, the Company s investment portfolio included $36.8 million, net of temporary impairment charges of $2.0 million, in auction-rate securities backed by municipal bonds and government-backed student loans, which the Company has classified as long-term investments. As of September 30, 2008, $38.8 million, the face value of the Company s auction-rate security investments, have failed to reset through successful auctions and it is unclear as to when these investments will regain their liquidity. The underlying maturity of these auction-rate securities is up to 30 years and the underlying credit quality of these instruments in which the Company has invested remains AAA rated.

To value the auction-rate securities at September 30, 2008, the discounted cash flow model used the following assumptions:

18-month time to liquidity;

discount rate of approximately 7.3%, which includes the 2-year LIBOR rate, the cost of debt and a liquidity risk premium; and

cash flows of approximately 3.9%, which includes the 2-year treasury rate plus a penalty premium, over the period in which these securities are not liquid.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Continued) (Unaudited)

Based on these assumptions, the Company recorded a temporary impairment on investments of $2.0 million during the nine months ended September 30, 2008 for these available-for-sale securities in accumulated other comprehensive income (loss) within equity. As a result, net assets decreased by $2.0 million. The temporary impairment charge had no impact on net income. The Company intends to hold these investments through successful auctions at par, which the Company believes could take approximately 1.5 years. Therefore, the Company reclassified all auction-rate securities as non-current on its balance sheet. The valuation is subject to fluctuations in the future, which will depend on many factors, including the collateral quality, potential to be called or restructured, underlying final maturity, insurance guaranty, liquidity and market conditions, among others. The Company experienced its first failed auction in mid-February 2008. If the auctions continue to fail, the liquidity of the Company s investment portfolio may be negatively impacted and the value of its investment portfolio could decline.

In October 2008, the Company received an offer to participate in an auction-rate securities rights offering from UBS to sell up to $18.2 million in eligible auction-rate securities commencing in June 2010. The offer gives the Company the right but not the obligation to sell these securities at par to UBS. In addition, accepting this offer will allow the Company to borrow up to $18.2 million beginning October 7, 2008. The Company is currently evaluating the offer, which expires on November 14, 2008 and which requires the Company to enter into a release of claims in favor of UBS.

10. ***Restatement***

Subsequent to the issuance of the Company s financial statements for the year ended December 31, 2007, the Company s management determined that there was an error in recording the tax effect of stock-based compensation expense related to Monolithic Power Systems, Inc. s cost-share agreement with a foreign subsidiary. As a result, the Company restated the accompanying condensed consolidated financial statements for the three and nine months ended September 30, 2007.

A summary of the effects of the restatement is shown below, which includes the following adjustments:

an error in the calculation of the tax effect of stock-based compensation expense related to Monolithic Power Systems, Inc. s cost-share agreement with a foreign subsidiary, which decreased the tax expense for the three months ended September 30, 2007 and decreased the tax expense recognized for the nine months ended September 30, 2007. The restatement also included adjustments to the cash flow effects related to the tax assets and liabilities and tax benefits within the Condensed Consolidated Statement of Cash Flows. There was no change to cash and cash equivalents as a result of these adjustments.

Condensed Consolidated Statements of Operations (in thousands, except per share amounts):

	For the three months ended September 30, 2007		For the nine months ended September 30, 2007	
	as previously reported	as restated	as previously reported	as restated
Income tax provision	$ 1,475	$ 752	$ 3,197	$ 2,857
Net income	$ 8,270	$ 8,993	$ 1,956	$ 2,298
Basic net income per share	$ 0.26	$ 0.28	$ 0.06	$ 0.07
Diluted net income per share	$ 0.23	$ 0.25	$ 0.06	$ 0.07

Condensed Consolidated Statement of Cash Flows (in thousands):

	Nine months ended September 30,	
	2007 (as previously	2007 (as restated)

	recorded)	
Cash flows from operating activities:		
Net income	$ 1,956	$ 2,298
Adjustments to reconcile net income to net cash provided by operating activities:		
Deferred income tax assets	$ 590	2,025
Tax benefit from stock option transactions	$ 3,049	3,096
Excess tax benefit from stock option transactions	$ (2,593)	(2,417)
Prepaid expenses and other current assets	$ (2,450)	(3,313)
Accrued income taxes payable and noncurrent tax liabilities	$ 2,772	1,812
Net cash provided by operating activities	$ 12,587	$ 12,764
Cash flows from financing activities:		
Excess tax benefits from stock option transactions	$ 2,593	$ 2,417
Net cash provided by financing activities	$ 15,274	$ 15,097

11. ***Income Tax Provision***

The income tax provision for the three and nine months ended September 30, 2008 was $0.5 million or 4.2% of the Company s income before income taxes and $1.7 million or 7.5% of the Company s income before income taxes, respectively. This differs from the federal statutory rate of 34% primarily because the Company s foreign income is taxed at lower rates and deductions from stock option exercises. The income tax provision for the three and nine months ended September 30, 2007 was $0.8 million or 7.7% of the pre-tax income and $2.9 million or 55.4% of the pre-tax income, respectively. This differs from the federal statutory rate of 34% primarily because the Company recorded an increase in the valuation allowance of its deferred tax assets in the amount of $1.5 million as the Company no longer expects that its deferred tax assets will be realized. Furthermore, the Company provided a full valuation allowance against the tax benefits from the unpaid portion of the TSE litigation settlement, which was offset by deductions from stock option exercises and the paid portion of the TSE litigation settlement in the second quarter of 2007.

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

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

- *the above-average industry growth of product and market areas that we have targeted,*
- *our plan to introduce additional new products within our existing product families as well as in new product categories,*
- *the impact of our outstanding litigation and environmental issues on the revenue we derive from our CCFL product line,*
- *the cyclical nature of the semiconductor industry,*
- *the factors that we believe will impact our ability to achieve revenue growth,*
- *the effect of auction-rate securities on our liquidity and capital resources, and*
- *estimates of our future liquidity requirements.*

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

The following discussion reflects the effects of the restatement discussed in Note 10 to the condensed consolidated financial statements.

Overview

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

We operate in the cyclical semiconductor industry where there is seasonal demand for certain of our products. While we will not be immune from future industry downturns or macroeconomic downturns, we have targeted product and market areas that we believe have the ability to offer above average industry growth over the long term.

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

Following the introduction of a product, our sales cycle generally takes six to twelve months to achieve revenue. Volume production is usually achieved in three to six months after we receive an initial customer order for a new product. Typical lead times for orders are fewer than 90 days.

These factors, combined with the fact that orders in the semiconductor industry can typically be cancelled or rescheduled without significant penalty to the customer, make the forecasting of our orders and revenue challenging.

We derive most of our revenue from sales through distribution arrangements or direct sales to customers in Asia, where the components we produce are incorporated into an end-user product. 91% of our revenue for the three months ended September 30, 2008 and 89% for the three months ended September 30, 2007 was attributable to direct or indirect sales to customers in

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

Critical Accounting Policies and Estimates

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

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

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

The majority of our sales are made through distribution arrangements with third parties. We recognize revenue upon our shipment to those third party distributors under these distribution arrangements. Some of these arrangements include limited stock rotation rights that permit the return of a small percentage of the previous six months purchases. We maintain a sales reserve for stock rotation rights, which is based on historical experience of actual stock rotation returns and information related to product in the distribution channel. We record an estimate of the stock rotation returns at the time of sale.

Our normal payment terms with our distributors are generally 30 to 45 days from invoice date, and our arrangements with our largest distributors do not include price protection provisions. In addition, terms in a majority of our distribution agreements include the non-exclusive right to sell, and the agreement to use best efforts to promote and develop a market for, our products in certain regions of the world and the ability to terminate the agreement by either party with up to three months notice. Estimated sales returns are based on historical experience and are recorded at the time product revenue is recognized.

In 2006, we signed a distribution agreement with a U.S. distributor. Revenue from this distributor is recognized upon sale by the distributor to the end customer because the distributor has certain rights of return which management believes are not estimable. For the three months ended September 30, 2008 and 2007, we recognized $0.4 million and $0.3 million, respectively, in revenue that is attributable to this distributor. For the nine months ended September 30, 2008 and 2007, we recognized $1.0 million and $0.7 million, respectively, in revenue that is attributable to this distributor. We also had a distribution and service agreement with a distributor for which the revenue is deferred until the services have been performed. Effective April 2008, this agreement ended. The remaining deferred revenue of $0.1 million is being recorded as resale occurs.

Warranty Reserves. We currently provide a 12-month warranty against defects in materials and workmanship and will either repair the goods or provide replacement products at no charge to the customer for defective products. We record estimated warranty costs by product, which are based on historical experience over the preceding 12 months by product, at the time we recognize product revenue. Reserve requirements are recorded in the period of sale and are based on an assessment of the

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products sold with warranty and historical warranty costs incurred. As the complexity of our products increases, we could experience higher warranty claims relative to sales than we have previously experienced, and we may need to increase these estimated warranty reserves.

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

Accounting for Income Taxes. FASB Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109, Accounting for Income Taxes* prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. We adopted the provisions of this interpretation on January 1, 2007. In accordance with SFAS No. 109, we recognize federal, state and foreign current tax liabilities or assets based on our estimate of taxes payable or refundable in the current fiscal year by tax jurisdiction. We also recognize federal, state and foreign deferred tax assets or liabilities for our estimate of future tax effects attributable to temporary differences and carryforwards. We record a valuation allowance to reduce any deferred tax assets by the amount of any tax benefits that, based on available evidence and judgment, are not expected to be realized.

Our calculation of current and deferred tax assets and liabilities is based on certain estimates and judgments and involves dealing with uncertainties in the application of complex tax laws. Our estimates of current and deferred tax assets and liabilities may change based, in part, on added certainty or finality or uncertainty to an anticipated outcome, changes in accounting or tax laws in the U.S., or foreign jurisdictions where we operate, or changes in other facts or circumstances. In addition, we recognize liabilities for potential U.S. and foreign income tax for uncertain income tax positions on the tax returns if it has less than a 50% likelihood of being sustained. If we determine that payment of these amounts is unnecessary or if the recorded tax liability is less than our current assessment, we may be required to recognize an income tax benefit or additional income tax expense in our financial statements in the period such determination is made. Due to the adoption of FIN 48 effective January 1, 2007, we calculated our uncertain tax positions which were attributable to certain estimates and judgments primarily related to transfer pricing, cost sharing and our international tax structure exposure.

As of September 30, 2008 and December 31, 2007, we had a valuation allowance of $11.9 million and $11.9 million, respectively, attributable to management s determination that none of the deferred tax assets will be realized, except for certain deferred tax assets related to uncertain income tax positions. Should it be determined that all or part of the net deferred tax asset will not be realized in the future, an adjustment to increase the deferred tax asset valuation allowance will be charged to income in the period such determination is made. Likewise, in the event we were to determine that we would be able to realize our deferred tax assets in the future in excess of our net recorded amount, an adjustment to the allowance for the deferred tax asset would increase income in the period such determination was made.

***Contingencies*.** We are engaged in legal proceedings resulting from several patent infringement actions against us. In addition, from time to time, we become aware that we are subject to other contingent liabilities. When this occurs, we will evaluate the appropriate accounting for the potential contingent liabilities using SFAS No. 5, *Accounting for Contingencies*, to determine whether a contingent liability should be recorded. In making this determination, management may, depending on the nature of the matter, consult with internal and external legal counsel and technical experts. Based on the facts and circumstances in each matter, we use our judgment to determine whether it is probable that a contingent loss has occurred and whether the amount of such loss can be estimated. If we determine a loss is probable and estimable, we record a contingent loss in accordance with SFAS 5. In determining the amount of a contingent loss, we take into account advice received from experts for each specific matter regarding the status of legal proceedings, settlement negotiations (which may be ongoing), prior case history and other factors. Should the judgments and estimates made by management need to be adjusted as additional information becomes available, we may need to record additional contingent losses that could materially and adversely impact our results of operations. Alternatively, if the judgments and estimates made by management are adjusted, for example, if a particular contingent loss does not occur, the contingent loss recorded would be reversed which could result in a favorable impact on our results of operations.

Accounting for Stock-Based Compensation. Effective January 1, 2006, we adopted the provisions of SFAS No. 123R, *Share-Based Payment*, under the modified prospective method. SFAS 123R eliminates the alternative of applying the intrinsic value measurement provisions of Accounting Principles Board (APB) Opinion 25 to stock compensation awards issued to employees. Rather, the standard requires us to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award. That cost will be recognized over the period

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during which an employee is required to provide services in exchange for the award, known as the requisite service period (usually the vesting period). We currently use the Black-Scholes option-pricing model to estimate the fair value of our share-based payments. The Black-Scholes option-pricing model is based on a number of assumptions, including expected volatility for which we use the average volatility of a number of our competitors and combine them with our limited historical volatility to come up with an overall volatility that is used in the model. The Black-Scholes option pricing model also includes an assumption of expected life, risk-free interest rate and expected dividends. If these assumptions change, stock-based compensation may differ significantly from what we have recorded in the past. The amount of stock-based compensation that we recognize is also based on an expected forfeiture rate. If there is a difference between the forfeiture assumptions used in determining stock-based compensation costs and the actual forfeitures which become known over time, we may change the forfeiture rate, which could have a significant impact on our stock-based compensation expense.

Investments in Auction Rate Securities. We account for our auction rate securities in accordance with Statement of Financial Accounting Standards No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, and classify them as available for sale. Investments in available-for-sale securities are recorded at fair value, and unrealized gains or losses (that are deemed to be temporary) are recognized, net of taxes, through shareholders equity, as a component of accumulated other comprehensive income in our consolidated balance sheet. We record an impairment charge to earnings when an investment has experienced a decline in value that is deemed to be other-than-temporary. In the first quarter of 2008, we revised the classification of investments in auction rate securities from short-term investments to long-term investments on our consolidated balance sheet. To date, we have recorded a temporary impairment charge of $2.0 million in accumulated other comprehensive income (loss) within equity.

Results of Operations

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

	Three months ended September 30,		Nine months ended September 30,	
	2008	2007	2008	2007
Revenue	100.0%	100.0%	100.0%	100.0%
Cost of revenue	37.2%	36.5%	37.0%	36.5%
Gross profit	62.8%	63.5%	63.0%	63.5%
Operating expenses:				
Research and development	19.3%	18.6%	20.3%	20.8%
Selling, general and administrative	19.6%	20.1%	21.6%	22.4%
Lease abandonment	0.0%	0.0%	0.0%	(0.5)%
Patent litigation settlement	0.0%	0.0%	0.0%	10.3%
Provision for litigation expense	2.2%	3.6%	4.9%	8.7%
Total operating expenses	41.1%	42.3%	46.8%	61.7%
Income from operations	21.7%	21.2%	16.2%	1.8%
Other income (expense):				
Interest and other income	1.4%	3.1%	2.3%	3.5%
Interest and other expense	(0.8)%	0.0%	(0.5)%	(0.0)%
Total other income, net	0.6%	3.1%	1.8%	3.5%
Income before income taxes	22.3%	24.3%	18.0%	5.3%
Income tax provision	0.9%	1.9%	1.3%	2.9%
Net income	21.4%	22.4%	16.7%	2.4%

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Revenue.

	For the three months ended September 30,			For the nine months ended September 30,		
	2008	2007		2008	2007	
	(in thousands)		Change	(in thousands)		Change
Revenue	$ 48,891	$ 40,188	21.7%	$ 125,802	$ 95,517	31.7%

Revenue for the three months ended September 30, 2008 was $48.9 million, an increase of $8.7 million, or 21.7%, from $40.2 million for the three months ended September 30, 2007. The increase in revenue between the two periods resulted primarily from increased sales of our DC to DC converters of $8.5 million. Revenue for the nine months ended September 30, 2008 was $125.8 million, an increase of $30.3 million, or 31.7%, from $95.5 million for the nine months ended September 30, 2007. The increase in revenue between these two periods resulted primarily from increased sales of our DC to DC converters of $26.7 million. For the three and nine months ended September 30, 2008, revenue from our DC to DC converters increased due to increased sales of consumer end market devices.

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

	For the three months ended September 30,					For the nine months ended September 30,				
	2008		2007			2008		2007		
	(in thousands) Amount	% of Revenue	(in thousands) Amount	% of Revenue	Change	(in thousands) Amount	% of Revenue	(in thousands) Amount	% of Revenue	Change
DC to DC Converters	$ 34,131	69.8%	$ 25,590	63.7%	33.4%	$ 88,113	70.0%	$ 61,448	64.3%	43.4%
LCD Backlight Inverters	10,335	21.1%	10,940	27.2%	-5.5%	27,064	21.5%	25,991	27.2%	4.1%
Audio Amplifiers	4,425	9.1%	3,658	9.1%	21.0%	10,625	8.4%	8,078	8.5%	31.5%
	$ 48,891	100.0%	$ 40,188	100.0%	21.7%	$ 125,802	100.0%	$ 95,517	100.0%	31.7%

While we have experienced significant revenue growth for the three and nine months ended September 30, 2008, and we continue to deliver innovative products, we recognize that there has recently been a deterioration in general demand for electronic products as a result of the worldwide financial crisis and associated macro-economic slowdown and we do not expect to be unaffected by such deterioration in demand.

Gross Profit. Gross profit as a percentage of revenue, or gross margin, was 62.8% for the three months ended September 30, 2008 and 63.5% for the three months ended September 30, 2007. Gross profit as a percentage of revenue was 63.0% for the nine months ended September 30, 2008 and 63.5% for the nine months ended September 30, 2007. For the three and nine months ended September 30, 2008 and 2007, gross margin declined year-over-year as a result of a slight decrease in the average selling price of certain of our mature DC to DC products.

Research and Development.

	For the three months ended September 30,			For the nine months ended September 30,		
	2008	2007		2008	2007	
	(in thousands)		Change	(in thousands)		Change
Revenue	$ 48,891	$ 40,188	21.7%	$ 125,802	$ 95,517	31.7%
Research and development (R&D) (including stock-based compensation of $1,471 and $1,326 for the three months ended September 30, 2008 and 2007, respectively, and $4,074 and $3,379 for the nine months ended September 30, 2008 and 2007, respectively)	$ 9,420	$ 7,489	25.8%	$ 25,594	$ 19,849	28.9%
R&D as a percentage of revenue	19.3%	18.6%		20.3%	20.8%	

R&D expenses were $9.4 million, or 19.3% of revenue, for the three months ended September 30, 2008 and $7.5 million, or 18.6% of revenue, for the three months ended September 30, 2007. R&D expenses were $25.6 million, or 20.3% of revenue, for the nine months ended September 30, 2008 and $19.8 million, or 20.8% of revenue, for the nine months ended September 30, 2007. The year-over-year increase in R&D expenses was primarily due to an increase in R&D headcount, new product development activities, bonus accruals and patent-related activities. The year-over-year increase for the nine months ended September 30, 2008 and 2007 was also due to an increase in stock-based compensation expenses of $0.7 million.

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Selling, General and Administrative.

	For the three months ended September 30,			For the nine months ended September 30,		
	2008	2007	Change	2008	2007	Change
	(in thousands)			(in thousands)		
Revenue	$ 48,891	$ 40,188	21.7%	$ 125,802	$ 95,517	31.7%
Selling, general and administrative (SG&A) (including stock-based compensation of $1,787 and $1,748 for the three months ended September 30, 2008 and 2007, respectively, and $5,141 and $4,296 for the nine months ended September 30, 2008 and 2007, respectively)	$ 9,560	$ 8,071	18.4%	$ 27,200	$ 21,387	27.2%
SG&A as a percentage of revenue	19.6%	20.1%		21.6%	22.4%	

SG&A expenses were $9.6 million, or 19.6% of revenue, for the three months ended September 30, 2008 and $8.1 million, or 20.1% of revenue, for the three months ended September 30, 2007. SG&A expenses were $27.2 million, or 21.6% of revenue, for the nine months ended September 30, 2008 and $21.4 million, or 22.4% of revenue, for the nine months ended September 30, 2007. SG&A expenses increased year-over-year due to an increase in headcount to support the growth in business, bonus accruals, sales commissions and sales representative contractual obligations. However, SG&A expenses as a percentage of revenue for both the three and nine months ended September 30, 2008 declined due to scaling efficiencies. The year-over-year increase for the nine months ended September 30, 2008 and 2007 was also due to an increase in stock-based compensation expenses in the amount of $0.8 million.

Lease Abandonment.

In December 2006, we abandoned our lease in Los Gatos and wrote off $1.2 million in operating expenses based on the fair value of the liability in accordance with Statement of Financial Accounting Standards No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*. In May 2007, we entered into a sublease agreement to rent a portion of our Los Gatos property for a period of 21 months commencing on June 1, 2007 during which we are to receive gross payments of $0.7 million. As the amount we expect to recover is greater than the amount we originally estimated, we reduced the estimate of our remaining liability by $0.5 million in the second quarter of 2007.

Patent Litigation Settlement.

In July 2007, we received an unfavorable ruling in our litigation with TSE, for which we recorded a provision for litigation of $9.8 million, or 31.8% of revenue.

Provision for Litigation Expense.

	For the three months ended September 30,			For the nine months ended September 30,		
	2008	2007	Change	2008	2007	Change
	(in thousands)			(in thousands)		
Revenue	$ 48,891	$ 40,188	21.7%	$ 125,802	$ 95,517	31.7%
Provision for litigation expense	$ 1,090	$ 1,452	(24.9%)	$ 6,120	$ 8,327	(26.5%)
Provision for litigation expense as a percentage of revenue	2.2%	3.6%		4.9%	8.7%	

Provision for litigation expenses, excluding settlement expenses of $9.8 million in 2007, were $1.1 million, or 2.2% of revenue, for the three months ended September 30, 2008 as compared to $1.5 million, or 3.6% of revenue, for the three months ended September 30, 2007. Provision for litigation expenses, excluding settlement expenses of $9.8 million in 2007, were $6.1 million, or 4.9% of revenue, for the nine months ended September 30, 2008 as compared to $8.3 million, or 8.7% of revenue, for the nine months ended September 30, 2007. We incurred significant legal expenses during the nine months ended September 30, 2008 for our lawsuit with Linear Technology. For the nine months ended

September 30, 2007, we incurred significant legal expenses to prepare for and try our cases against O2 Micro and TSE.

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Income Tax Provision. The income tax provision for the three and nine months ended September 30, 2008 was $0.5 million or 4.2% of our income before income taxes and $1.7 million or 7.5% of our income before income taxes, respectively. This differs from the federal statutory rate of 34% primarily because our foreign income is taxed at lower rates and deductions from stock option exercises. The income tax provision for the three and nine months ended September 30, 2007 was $0.8 million or 7.7% of the pre-tax income and $2.9 million or 55.4% of the pre-tax income, respectively. This differs from the federal statutory rate of 34% primarily because we recorded an increase in the valuation allowance of our deferred tax assets in the amount of $1.5 million as we no longer expect that our deferred tax assets will be realized. Furthermore, we provided a full valuation allowance against the tax benefits from the unpaid portion of the TSE litigation settlement, which was offset by deductions from stock option exercises and the paid portion of the TSE litigation settlement in the second quarter of 2007.

Liquidity and Capital Resources.

As of September 30, 2008, we had working capital of $114.5 million, including cash and cash equivalents of $75.9 million and short-term investments of $8.7 million compared to working capital of $119.3 million, including cash and cash equivalents of $83.1 million and short-term investments of $27.8 million as of December 31, 2007. During the quarter ended March 31, 2008, we reclassified $39.6 million in auction-rate securities from-short-term investments to long-term investments. To date, we sold $0.7 million in long-term investments and recorded a temporary impairment of $2.0 million for these available-for-sale securities in accumulated other comprehensive income (loss) within equity. We have financed our growth primarily with proceeds from cash generated from operating activities, the issuance of common stock and the exercise of stock options.

For the nine months ended September 30, 2008, net cash provided by operating activities was $18.9 million, primarily due to strong sales during the nine months ended September 30, 2008. Accounts receivable increased due to increased sales in the third quarter of 2008. Inventory increased due to anticipated future demand for our products. Net cash provided by operating activities was $12.8 million for the nine months ended September 30, 2007 due to an increase in sales. This was offset by an increase in accrued liabilities, primarily due to a provision for litigation of $9.8 million to settle the TSE lawsuit and an increase in inventory purchases in anticipation of future demand. Accounts receivable and accounts payable increased as a result of increased sales and inventory purchases, respectively.

For the nine months ended September 30, 2008, net cash used in investing activities was $21.1 million, primarily related to the purchase of investments which we were not able to sell during the period due to the illiquidity related to auction-rate securities and the purchase of $3.6 million in capital equipment. For the nine months ended September 30, 2007, we used $1.3 million, primarily due to net proceeds from our investments in the amount of $3.3 million, partially offset by capital equipment purchases in the US and Chengdu of $4.6 million.

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

The market for auction-rate securities, which are generally issued by municipalities with interest rates that reset through a Dutch auction every 7 to 35 days, became illiquid earlier in 2008. As of September 30, 2008, our investment portfolio included $36.8 million, net of temporary impairment charges of $2.0 million, in auction-rate securities backed by government-backed student loans. As of that date, $38.8 million, the face value of our auction-rate security investments, have failed to reset through successful auctions and it is unclear as to when these investments will regain their liquidity. The underlying maturity of these auction-rate securities is up to 30 years and the underlying credit quality of these instruments in which we have invested remains AAA rated.

We adopted the provisions of SFAS No. 157, *Fair Value Measurements,* effective January 1, 2008. This Statement defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles in the United States of America, and expands disclosures about fair value measurements. SFAS No. 157 applies to the auction-rate securities in which hawse have invested, the fair value of which was determined using the discounted cash flow model. The discounted cash flow model at September 30, 2008 used the following assumptions:

18-month time to liquidity;

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discount rate of approximately 7.3%, which includes the 2-year LIBOR rate, the cost of debt and a liquidity risk premium; and

cash flows of approximately 3.9%, which includes the 2-year treasury rate plus a penalty premium, over the period in which these securities are not liquid.

Based on these assumptions, we recorded a temporary impairment of $2.0 million for these available-for-sale securities in accumulated other comprehensive income (loss) within equity. We intend to hold these investments through successful auctions at par, which we believe could take 1.5 years. The valuation, however, is subject to fluctuations in the future, which will depend on many factors, including the collateral quality, potential to be called or restructured, underlying final maturity, insurance guaranty, liquidity and market conditions, among others. We experienced our first failed auction in mid-February 2008. If the auctions continue to fail, the liquidity of the our investment portfolio may be negatively impacted and the value of its investment portfolio could decline.

In October 2008, we received an offer to participate in an auction-rate securities rights offering from UBS to sell up to $18.2 million in eligible auction-rate securities commencing in June 2010. The offer gives us the right but not the obligation to sell these securities at par to UBS. In addition, accepting this offer will allow us to borrow up to $18.2 million beginning October 7, 2008. We are currently evaluating the offer, which expires on November 14, 2008 and which requires us to enter into a release of claims in favor of UBS.

Net cash used by financing activities for the nine months ended September 30, 2008 was $5.0 million, primarily from the repurchase of $20.0 million of our common stock of which our Board approved a repurchase of up to $25.0 million. This was partially offset by the proceeds related to the issuance of common stock in the amount of $14.4 million and excess tax benefits related to the exercise of options of $0.6 million. Net cash provided by financing activities for the nine months ended September 30, 2007 was $15.1 million, primarily from the issuance of common stock in the amount of $12.7 million and excess tax benefits related to the exercise of options in the amount of $2.4 million.

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

Contractual Obligations and Off Balance Sheet Arrangements.

We lease our headquarters in San Jose, California under a non-cancelable operating lease which expires in October 2009. Although we relocated our headquarters from Los Gatos, California to San Jose, we have a non-cancelable lease on our Los Gatos facility which expires in February 2009, for which we signed an agreement in May 2007 to sublease a portion of the property for the remaining term. Certain of our facility leases provide for periodic rent increases. In addition, as described below, we have a five-year lease arrangement which we entered into in September 2004 for our manufacturing facility located in Chengdu, China. We also lease our sales offices in Japan, China, Taiwan and Korea.

In the fourth quarter of 2007, we qualified a second source foundry and have incorporated their wafers in our production units. There were no material changes to our contractual obligations since December 31, 2007. However, as of September 30, 2008, our total outstanding purchase commitments were $7.8 million, which includes wafer purchases from our contracted foundries and the purchase of assembly services primarily from two contractors in Asia. This compares to purchase commitments of $9.1 million as of December 31, 2007.

As of September 30, 2008, we had no off-balance sheet arrangements as defined in Item 303(a)(4) of the Securities and Exchange Commission s Regulation S-K.

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

For a discussion of market risks at December 31, 2007, refer to Item 7A, Quantitative and Qualitative Disclosures about Market Risk in our amended annual report on Form 10-K/A for the fiscal year ended December 31, 2007 filed with the SEC on May 12, 2008. During the nine months ended September 30, 2008, there were no material changes or developments that would materially alter the market risk assessment performed as of December 31, 2007.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of disclosure controls and procedures.

Our management, with the participation of our chief executive officer and chief financial officer, evaluated the effectiveness of our disclosure controls and procedures pursuant to Rule 13a-15(e) under the Securities Exchange Act of 1934 as of the end of the period covered by this Quarterly Report on Form 10-Q. In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives. In addition, the design of disclosure controls and procedures must reflect the fact that there are resource constraints and that management is required to apply its judgment in evaluating the benefits of possible controls and procedures relative to their costs. Based on this evaluation and because of the material weakness described below, our chief executive officer and chief financial officer have concluded that our disclosure controls and procedures were not effective as of September 30, 2008.

As disclosed in the Explanatory Note of this Quarterly Report on Form 10-Q, the Audit Committee of our Board of Directors determined on April 28, 2008 that our previously issued financial statements for the years ended December 31, 2006 and 2007 contained a material error thus requiring the restatement of such financial statements. We have determined that our accounting for the tax effect of stock-based compensation related to our cost-share agreement with a foreign subsidiary was not recorded correctly.

As more fully described in our amended annual report on Form 10-K/A filed on May 12, 2008, we did not maintain, as of December 31, 2007, effective internal control over financial reporting related to accounting for certain tax effects of stock-based compensation. As a result, our management concluded that these control deficiencies that resulted in the need for a restatement of our previously issued consolidated financial statements constituted a material weakness as of December 31, 2007 that has continued through September 30, 2008.

A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company s annual or interim financial statements will not be prevented or detected on a timely basis. The following material weakness as of December 31, 2007 was identified and reported in our amended annual report on Form 10-K/A, filed with the Securities and Exchange Commission on May 12, 2008:

> A material weakness exists in the operating effectiveness of the controls over the calculation of the tax effect of stock-based compensation expenses related to our cost-share agreement with a foreign subsidiary. This control deficiency led to a misstatement of certain tax-related accounts in 2007 and 2006, which was not prevented or detected on a timely basis, and a restatement of MPS s 2007 and 2006 consolidated financial statements.

Changes in internal control over financial reporting.

We made no changes to our internal control over financial reporting during the three-month period ended September 30, 2008, except for the continuation of the remedial efforts as described below to address the material weakness described above.

Remedial Efforts to Address the Material Weakness

Following the identification of the material weakness in the second quarter of fiscal 2008, we initiated remediation measures to address the material weakness over the accounting for income taxes, which included replacing our external tax advisors and corresponding external tax review team. The team has been in place since the second quarter of 2008 and in the third quarter of 2008, we have continued to improve our review process for the tax provision computation.

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PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

O2 Micro, Inc.

Since November 2000, we have been engaged in multiple legal proceedings involving patent infringement claims with O2 Micro, Inc. and its parent corporation, O2 Micro International Limited (referred to hereinafter as O2). All of these claims relate to our CCFL backlight inverter products, which are part of its LCD backlight inverter family. For further information regarding the history of these legal proceedings, refer to our filings on Forms 10-K and related amendments, 10-Q and 8-K.

In the United States District Court for the Northern District of California, O2 alleged that certain of our CCFL products infringe O2 s 722 patent. On October 30, 2007, the Court entered judgment that all of the 722 patent claims asserted by O2 against us are invalid and denied all post-trial motions. Subsequently, O2 filed an appeal, and we filed a cross-appeal with the Federal Circuit. The appeals are currently pending.

On May 1, 2007, we filed for declaratory judgment relief in the United States District Court for the Northern District of California against O2 that certain of our CCFL products do not infringe O2 s 129 patent and that the 129 patent is invalid and unenforceable. On August 20, 2008, the parties filed a joint stipulation to a dismissal with prejudice of their respective claims for relief in which O2 covenants not to assert or reassert its 129 patent against us or our direct and indirect customers for infringement by our series of power inverter controller products.

On September 30, 2008, based on information and belief that O2 had alleged to our customer that certain of our inverter controller products infringe O2 s patents, we filed for declaratory judgment relief in the United States District Court for the Northern District of California against O2 that those products do not infringe O2 s 6,856,519 (519) patent family. This case is still in the early proceedings.

In addition to the U.S. litigation described above, O2 has brought various legal proceedings against us in Taiwan based upon a Taiwan patent. We previously posted cash bonds of approximately $7.9 million with the Taiwan Courts in support of our counter-injunctions and to prevent O2 from seizing our assets. In July 2008, the parties agreed to cease all provisional remedial disputes against each other and allow the parties to retrieve the bonds posted. As a result of the agreement, we retrieved a portion of the bonds in the amount of approximately $1.8 million in the third quarter of 2008 and the remaining portion in October 2008. The remaining $6.1 million is currently recorded as short-term restricted assets on our consolidated balance sheet as of September 30, 2008.

Taiwan Sumida Electronics

On July 30, 2007, we settled our litigation with TSE concerning the Indemnification Agreement. As of September 30, 2008, we had $7.4 million held in escrow for which we could be liable subject to the outcome of certain legal activities which are still pending in front of the Federal Circuit Court of Appeal.

Linear Technology Corporation

On July 1, 2008, the United States District Court for the District of Delaware issued a judgment as a matter of law that we did not breach its October 1, 2005 Settlement and License Agreement with Linear. We plan to seek recovery of our attorney fees and costs from Linear, pursuant to a prevailing party attorneys fees provision in the Settlement and License Agreement. However, there can be no assurance that we can be successful in obtaining such recovery.

The court also found as a matter of law that we did not willfully infringe the patent claims of U.S. Patent Numbers 5,481,178 and 6,580,258 asserted by Linear against MPS accused MP1543 product, which has been discontinued. However, the jury returned a verdict that an evaluation board containing the previously discontinued MP1543 product had directly infringed the asserted patent claims and that Linear s patents mentioned above are valid. The parties had stipulated to a total of ten dollars in nominal patent infringement damages in the event that Linear prevailed in that dispute. The court has not issued a final judgment concerning the patent infringement and validity claims.

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Chip Advanced Technology Inc.

On December 12, 2007, we filed a patent infringement lawsuit in the U.S. District Court for the Central District of California against Chip Advanced Technology Inc. (CAT), asserting that CAT willfully infringed a MPS patent that enables efficient low voltage, low current power conversions, such as DC-DC step down converters. In the complaint, MPS seeks unspecified damages and a court-ordered injunction against future infringement by CAT. On September 16, 2008, we amended our complaint to add trade secret misappropriation claims against CAT. Through this lawsuit, MPS intends to vigorously protect and enforce its intellectual property. As the case is in its early stages, we are not able to determine the outcome of the litigation.

ITEM 1A. RISK FACTORS

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

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

We are engaged in legal proceedings with O2. These proceedings involve various claims and counterclaims in the United States and Taiwan alleging, among other things, patent infringement. O2 has also taken legal action against one of our customers of our products in Taiwan, which we are indemnifying, and against one of our suppliers. We are also involved in litigation with CAT. See the Legal Proceedings section in Part II, Item 1 of this quarterly report on Form 10-Q for more information.

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

In July 2007, we settled our litigation with Taiwan Sumida Electronics, Inc. (TSE) concerning our December 25, 2002 Indemnification Agreement with TSE. If certain conditions are met under the Settlement Agreement, we could be liable for additional potential payments up to a total sum of $7.4 million, which is currently held in escrow, subject to the outcome of certain legal activities.

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

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

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

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

The market for auction-rate securities, which are generally issued by municipalities with interest rates that reset every 7 to 35 days, has recently suffered a decline in liquidity which may impact the liquidity and potential value of our investment portfolio.

The market for auction-rate securities, which are generally issued by municipalities with interest rates that reset through a Dutch auction every 7 to 35 days, became illiquid earlier in 2008. As of September 30, 2008, our investment portfolio included $36.8 million, net of temporary impairment charges of $2.0 million, in auction-rate securities backed by municipal bonds and government-backed student loans. As of that date, $38.8 million, the face value of our auction-rate security investments, have failed to reset through successful auctions and it is unclear as to when these investments will regain their liquidity. The underlying maturity of these auction-rate securities is up to 30 years and the underlying credit quality of these instruments in which we have invested remains AAA rated.

Based on certain assumptions described in the Liquidity and Capital Resources section of Part I, Item 2 of this quarterly report on Form 10-Q, we recorded a temporary impairment on investments through September 30, 2008 of $2.0 million for these available-for-sale securities in accumulated other comprehensive income (loss) within equity. The valuation is subject to fluctuations in the future, which will depend on many factors, including the collateral quality, potential to be called or restructured, underlying final maturity, insurance guaranty, liquidity and market conditions, among others. We experienced our first failed auction in mid-February 2008. Although we recently received an offer to participate in an auction-rate securities rights offering from UBS to sell up to $18.2 million in eligible auction-rate securities at par to UBS commencing in June 2010, if this rights offering is not successful or the auctions continue to fail, the liquidity of our investment portfolio may be negatively impacted and the value of our investment portfolio could decline.

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

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

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

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

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

product performance;

the quality and reliability of the product; and

effective marketing, sales and service.

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

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

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

Moreover, approximately 21% of our business is based on products that are used in systems that contain CCFL. CCFL tubes contain mercury, which is the subject of environmental concerns, particularly in Europe. Should environmental issues impair the widespread use of our CCFL-based products, and should we be unable to produce replacement products based on LED lighting fast enough to compensate for the loss of our CCFL-related business, our business and results of operations could be adversely affected.

We may not experience growth rates comparable to past years.

In the past, our revenues increased significantly in certain years due to increased sales of certain of our products. Due to increased competition, market acceptance and penetration of our current and future products and ongoing litigation, we may not experience growth rates comparable to past periods, which could affect our stock price and results of operations.

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

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

- the timing of developments and related expenses in our litigation matters with O2, TSE, Linear and CAT and any future litigation;
- the possibility of additional lost business as a result of customer and prospective customer concerns about adverse outcomes in our litigations or about being litigation targets;
- continued dependence on our turns business (orders received and shipped within the same fiscal quarter);
- increases in assembly costs due to commodity price increases;
- the timing of new product introductions by us and our competitors;
- the acceptance of our new products in the marketplace;
- our ability to develop new process technologies and achieve volume production;

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

the cyclical nature of demand for our customers products;

inventory levels and product obsolescence;

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

the availability of adequate manufacturing capacity from our outside suppliers**;**

changes in manufacturing yields;

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

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

movements in exchange rates, interest rates or tax rates.

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

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

Our profitability is dependent on many factors, including:

- our sales, which because of our turns business, is difficult to accurately forecast;
- our competition, which could adversely impact our selling prices and our potential sales;
- our manufacturing costs, including our ability to negotiate with our vendors and our ability to efficiently run our test facility in China; and
- our operating expenses, including general and administrative expenses, selling and marketing expenses, stock-based compensation expenses, litigation expenses, which we expect to be significant due to the litigation in which we are involved, and research and development expenses relating to products that will not be introduced and will not generate revenue until later periods, if at all.

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

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

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

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

We market our products through distribution arrangements and through our direct sales and applications support organization to customers that include OEMs, ODMs and electronic manufacturing service providers. Receivables from our customers are not secured by any type of collateral and are subject to the risk of being uncollectible. For the quarter ended September 30, 2008, sales to our three largest distributors accounted for approximately 42% of our total revenue. Significant deterioration in the liquidity or financial condition of any of our major customers or any group of our customers could have a material adverse impact on the collectibility of our accounts receivable and our future operating results. We primarily conduct our sales on a purchase order basis, and we do not have any long-term supply contracts.

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

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

We rely heavily on our proprietary technologies. Our future success and competitive position depend in part upon our ability to obtain and maintain protection of certain proprietary technologies used in our products. We pursue patents for some of our new products and unique technologies, and we also rely on a combination of nondisclosure agreements and other contractual provisions, as well as our employees commitment to confidentiality and loyalty, to protect our technology, know-how, and processes. Despite the precautions we take, it may be possible for unauthorized third parties to copy aspects of our current or future technology or products or to obtain and use information that we regard as proprietary. We intend to continue to protect our proprietary technology, including through patents. However, there can be no assurance that the steps we take will be

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adequate to protect our proprietary rights, that our patent applications will lead to issued patents, that others will not develop or patent similar or superior products or technologies, or that our patents will not be challenged, invalidated, or circumvented by others. Furthermore, the laws of the countries in which our products are or may be developed, manufactured, or sold may not protect our products and intellectual property rights to the same extent as laws in the United States. Our failure to adequately protect our proprietary technologies could harm our business.

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

Our customers generally establish demanding specifications for quality, performance, and reliability that our products must meet. Integrated circuits as complex as ours often encounter development delays and may contain undetected defects or failures when first introduced or after commencement of commercial shipments, which might require product replacement or recall. We have from time to time in the past experienced product quality, performance or reliability problems. In 2005, we extended our standard warranty period from 90 days to one year. As a result, we now have an increased risk of claims for defects and failures. If defects and failures occur in our products, we could experience lost revenue, increased costs, including warranty expense and costs associated with customer support, delays in, cancellations or rescheduling of orders or shipments, and product returns or discounts, any of which would harm our operating results.

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

We currently depend on two third-party suppliers to provide us with wafers for our products. If our wafer suppliers fail to provide us sufficient wafers at acceptable yields and at anticipated costs, our revenue and gross margin may decline or we may not be able to fulfill our customer orders.

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

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

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

O2 sued ASMC, one of our suppliers, for patent infringement because ASMC manufactures our products. It is possible that our relationship with ASMC or any other supplier could be materially and adversely affected by the O2 litigation.

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

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

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

We derive most of our revenue from customers located in Asia through direct or indirect sales through distribution arrangements with parties located in Asia. As a result, we are subject to increased risks due to this geographic concentration of business and operations. For the quarter ended September 30, 2008, approximately 91% of our revenue was from customers in Asia. There are risks inherent in doing business internationally, including:

changes in, or impositions of, legislative or regulatory requirements, including tax laws in the United States and in the countries in which we manufacture or sell our products;

trade restrictions, including restrictions imposed by the United States government on trading with parties in foreign countries;

currency exchange rate fluctuations impacting intra-company transactions;

transportation delays;

recent changes in tax regulations in China may impact our tax status in Chengdu;

multi-tiered distribution channels that lack visibility to end customer pricing and purchase patterns;

international political relationships and threats of war;

terrorism and threats of terrorism;

epidemics and illnesses;

work stoppages and infrastructure problems due to adverse weather conditions or natural disasters;

economic and political instability;

changes in import/export regulations, tariffs, and freight rates;

longer accounts receivable collection cycles and difficulties in collecting accounts receivables;

enforcing contracts generally; and

less effective protection of intellectual property and contractual arrangements.

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

Our products incorporate commodities such as gold, platinum, copper and silicon. The price and availability of these commodities and other like commodities that we use could negatively impact our business and results of operations.

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

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

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

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

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

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

We have a testing facility in China that began operations in 2006. In addition to the risks discussed elsewhere in this quarterly report, we face the following risks, among others:

- inability to maintain appropriate and acceptable manufacturing controls; and
- higher than anticipated overhead and other costs of operation.

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

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

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

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

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

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

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

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

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

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

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

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

Due to the complexity associated with the calculation of our tax provision, we have hired independent tax advisors to assist us in the calculation. If we or our independent tax advisors fail to resolve or fully understand certain issues, we could be subject to errors, which would result in us having to restate our financial statements. Restatements are generally costly and could adversely impact our results of operations and/or have a negative impact on the trading price of our common stock.

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

In accordance with Section 404 of the Sarbanes-Oxley Act, we are required to include in our annual report on Form 10-K, a management report regarding the effectiveness of our internal control over financial reporting as such term is defined in Rule 13a-15(f) and Rule 15d-15(f) under the Securities Exchange Act of 1934. This report must include disclosure of any material weakness in our internal control over financial reporting. In preparation for issuing this management report, we document, evaluate and test our internal control over financial reporting.

As a result of an error in our tax provision for the years ended December 31, 2007 and 2006, we restated our consolidated financial statements included in our annual report on Form 10-K/A for the years ended December 31, 2007 and 2006. In conjunction with these restatements and our assessment of the effectiveness of our internal control over financial reporting, we identified a material weakness, as follows:

- A material weakness exists in the operating effectiveness of the controls over the calculation of the tax effect of stock-based compensation expenses related to our cost-share agreement with a foreign subsidiary. This control deficiency led to a misstatement

of certain tax-related accounts in 2007 and 2006, which was not prevented or detected on a timely basis, and a restatement of MPS s 2007 and 2006 consolidated financial statements.

No material weakness will be considered remediated until any remedial procedures that we take have operated for an appropriate period, have been tested, and management has concluded that they are operating effectively. We cannot be certain that any measures we have taken or may take in the future will ensure that we implement and maintain adequate internal control over financial reporting and that we will remediate the material weakness. In addition, we cannot assure you that we will not in the future identify further material weaknesses in our internal control over financial reporting that we have not discovered to date, which may impact the reliability of our financial reporting and financial statements.

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

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

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

Since 2006, we significantly increased the quantity and quality of our sales, applications, financial and legal staff. However, if we fail to continue to adequately staff these areas and maintain internal controls that meet the demands of our business, our ability to operate effectively will suffer. The operation of our business also depends upon our ability to retain these employees, as these employees hold a significant amount of institutional knowledge about us and our products, and, if they were to terminate their employment, our sales and internal control over financial reporting could be adversely affected.

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

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

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

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

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

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

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

The analog and mixed-signal semiconductor industry is highly competitive, and we expect competitive pressures to continue. Our ability to compete effectively and to expand our business will depend on our ability to continue to recruit applications and design talent, our ability to introduce new products, and our ability to maintain the rate at which we introduce these new products. We compete with domestic and non-domestic semiconductor companies, many of which have substantially greater

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financial and other resources with which to pursue engineering, manufacturing, marketing, and distribution of their products. We are in direct and active competition, with respect to one or more of our product lines, with at least 10 manufacturers of such products, of varying size and financial strength. The number of our competitors has grown due to the expansion of the market segments in which we participate. We consider our competitors to include, but not be limited to: Analog Devices, Fairchild Semiconductor, Intersil, Linear, Maxim Integrated Products, Micrel, Microsemi, National Semiconductor, O2, RichTech, Semtech, STMicroelectronic and Texas Instruments. We expect continued competition from existing competitors as well as competition from new entrants in the semiconductor market.

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

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

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

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

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

conditions and trends in technology industries;

changes in market valuation or earnings of our competitors;

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

our results of operations and financial performance; and

general economic, industry and market conditions.

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

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

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

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

Executive officers, directors, and affiliated entities beneficially own in aggregate, approximately 15% of our outstanding common stock as of September 30, 2008. These stockholders, if acting together, would be able to significantly influence all matters requiring approval by our stockholders, including the election of directors and the approval of mergers or other business combination transactions.

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

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

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

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ITEM 6. EXHIBITS

3.1(1)	Amended and Restated Certificate of Incorporation
3.2(2)	Amended and Restated Bylaws
31.1	Certification of Chief Executive Officer pursuant to Securities Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Chief Financial Officer pursuant to Securities Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1*	Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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

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

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

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MONOLITHIC POWER SYSTEMS, INC

SIGNATURE

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

MONOLITHIC POWER SYSTEMS, INC.

Dated: October 23, 2008

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

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