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**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2010

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
(State or other jurisdiction of
incorporation or organization)

77-0466789
(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 ☒ No ☐

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ☐ 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 ☒

Non-accelerated filer ☐

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 ☒

There were 36,012,255 shares of the registrant's common stock issued and outstanding as of April 20, 2010.

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MONOLITHIC POWER SYSTEMS, INC.

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MONOLITHIC POWER SYSTEMS, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands, except par value and share amounts)
(Unaudited)

	<u>March 31, 2010</u>	<u>December 31, 2009</u>
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 48,865	\$ 46,717
Short-term investments	126,724	118,914
Accounts receivable, net of allowances of \$0 in both 2010 and 2009	24,541	15,521
Inventories	14,550	19,616
Deferred income tax assets, net - current	5	5
Prepaid expenses and other current assets	2,491	2,726
Total current assets	<u>217,176</u>	<u>203,499</u>
Property and equipment, net	21,696	17,968
Long-term investments	19,555	19,445
Deferred income tax assets, net - long-term	175	175
Other assets	713	734
Total assets	<u>\$ 259,315</u>	<u>\$ 241,821</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 11,681	\$ 7,787
Accrued compensation and related benefits	6,481	8,454
Accrued liabilities	7,293	7,681
Total current liabilities	<u>25,455</u>	<u>23,922</u>
Non-current income tax liability	4,915	4,915
Other long-term liabilities	58	27
Total liabilities	<u>30,428</u>	<u>28,864</u>
Stockholders' equity:		
Common stock, \$0.001 par value, \$36 and \$35 in 2010 and 2009, respectively; shares authorized: 150,000,000; shares issued and outstanding: 35,755,150 and 35,165,316 in 2010 and 2009, respectively	184,860	175,518
Retained earnings	43,440	37,085
Accumulated other comprehensive income	587	354
Total stockholders' equity	<u>228,887</u>	<u>212,957</u>
Total liabilities and stockholders' equity	<u>\$ 259,315</u>	<u>\$ 241,821</u>

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 March 31,	
	2010	2009
Revenue	\$ 50,250	\$ 29,322
Cost of revenue	20,954	12,431
Gross profit	29,296	16,891
Operating expenses:		
Research and development	11,040	8,117
Selling, general and administrative	10,393	7,808
Litigation expense	1,567	2,046
Total operating expenses	23,000	17,971
Income (loss) from operations	6,296	(1,080)
Other income (expense):		
Interest and other income	347	385
Interest and other expense	—	(94)
Total other income, net	347	291
Income (loss) before income taxes	6,643	(789)
Income tax provision (benefit)	287	(61)
Net income (loss)	\$ 6,356	\$ (728)
Basic net income (loss) per share	\$ 0.18	\$ (0.02)
Diluted net income (loss) per share	\$ 0.17	\$ (0.02)
Weighted average common shares outstanding	35,421	33,696
Stock options	2,362	—
Diluted weighted-average common equivalent shares outstanding	37,783	33,696

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)

	Three months ended March 31,	
	2010	2009
Cash flows from operating activities:		
Net income (loss)	\$ 6,356	\$ (728)
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	1,723	1,537
Amortization and realized gain (loss) on debt instruments	127	30
Tax benefit from stock option transactions	567	231
Excess tax benefit from stock option transactions	(215)	(9)
Stock-based compensation	4,024	3,413
Changes in operating assets and liabilities:		
Accounts receivable	(9,019)	(4,252)
Inventories	5,066	326
Prepaid expenses and other assets	238	(165)
Accounts payable	2,032	3,198
Accrued and long-term liabilities	(357)	1,038
Accrued income taxes payable and noncurrent tax liabilities	(353)	(201)
Accrued compensation and related benefits	(1,956)	(3,998)
Net cash provided by operating activities	<u>8,233</u>	<u>420</u>
Cash flows from investing activities:		
Property and equipment purchases	(3,570)	(859)
Purchase of short-term investments	(46,037)	(28,015)
Proceeds from sale of short-term investments	38,148	11,834
Proceeds from sale of long-term investments	75	—
Net cash used in investing activities	<u>(11,384)</u>	<u>(17,030)</u>
Cash flows from financing activities:		
Proceeds from issuance of common stock	4,047	587
Proceeds from employee stock purchase plan	1,054	930
Excess tax benefits from stock option transactions	215	9
Net cash provided by financing activities	<u>5,316</u>	<u>1,526</u>
Effect of change in exchange rates	(17)	(88)
Net increase (decrease) in cash and cash equivalents	<u>2,148</u>	<u>(15,172)</u>
Cash and cash equivalents, beginning of period	46,717	83,266
Cash and cash equivalents, end of period	<u>\$ 48,865</u>	<u>\$ 68,094</u>
Supplemental disclosures for cash flow information:		
Cash paid for taxes	<u>\$ 159</u>	<u>\$ 45</u>
Supplemental disclosures of non-cash investing and financing activities:		
Liability accrued for equipment purchases	<u>\$ 2,526</u>	<u>\$ 492</u>
Temporary impairment of auction-rate securities	<u>\$ (185)</u>	<u>\$ 35</u>

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 filed with the SEC on February 12, 2010.

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, 2010 or for any other future period.

Recent Accounting Pronouncements

In October 2009, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2009-13, “*Multiple-Deliverable Revenue Arrangements*” (“ASU 2009-13”). The new standard changes the requirements for establishing separate units of accounting in a multiple element arrangement and requires the allocation of arrangement consideration to each deliverable to be based on the relative selling price. ASU 2009-13 is effective for fiscal years beginning on or after June 15, 2010. The Company is currently evaluating ASU 2009-13 and the impact, if any, that it may have on its results of operations or financial position.

In January 2010, the FASB issued ASU No. 2010-06, “*Disclosures About Fair Value Measurements*”, which amend ASC No. 820, “*Fair Value Measurements*” to add new requirements for disclosures about transfers into and out of Levels 1 and 2 and separate disclosures about purchases, sales, issuances, and settlements relating to Level 3 measurements. The ASU also clarifies existing fair value disclosures about the level of disaggregation and about inputs and valuation techniques used to measure fair value. This ASU is effective for the first reporting period (including interim periods) beginning after December 15, 2009. The Company has adopted this standard effective January 1, 2010 and has and will make the appropriate disclosures, as required.

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 months ended March 31, 2010 and 2009, as follows (in thousands):

	Three months ended March 31,	
	2010	2009
Non-Employee	\$ 1	\$ 14
ESPP	227	137
Restricted Stock	1,610	739
Stock Options	2,186	2,523
TOTAL	\$ 4,024	\$ 3,413

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.

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MONOLITHIC POWER SYSTEMS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Continued) (Unaudited)

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 1/48th 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, 2009	2,023,943
2010 Additions to Plan	1,758,265
2010 Grants	(876,340)
2010 Cancellations	<u>144,142</u>
Available for Grant as of March 31, 2010	<u><u>3,050,010</u></u>

A summary of the status of the Company's stock option plans at March 31, 2010 and changes during the three months then ended is presented in the table below:

	<u>Stock Options</u>	<u>Weighted Average Exercise Price</u>	<u>Weighted Average Remaining Contractual Term (Years)</u>	<u>Aggregate Intrinsic Value</u>
Outstanding at December 31, 2009	<u>7,410,914</u>	<u>\$ 13.48</u>	<u>5.04</u>	<u>\$77,918,848</u>
Options granted (weighted-average fair value of \$9.24 per share)	207,000	\$ 20.40		
Options exercised	(482,023)	\$ 8.40		
Options forfeited and expired	<u>(143,142)</u>	<u>\$ 17.97</u>		
Outstanding at March 31, 2010	<u><u>6,992,749</u></u>	<u><u>\$ 13.95</u></u>	<u><u>4.92</u></u>	<u><u>\$59,172,134</u></u>
Options exercisable at March 31, 2010 and expected to become exercisable	<u>6,574,336</u>	<u>\$ 13.75</u>	<u>4.90</u>	<u>\$56,885,311</u>
Options vested and exercisable at March 31, 2010	<u><u>4,191,802</u></u>	<u><u>\$ 11.78</u></u>	<u><u>4.57</u></u>	<u><u>\$44,424,952</u></u>

[Table of Contents](#)**MONOLITHIC POWER SYSTEMS, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****(Continued) (Unaudited)**

The total fair value of options that vested during the three months ended March 31, 2010 and 2009 was \$2.2 million and \$2.5 million, respectively. The total intrinsic value of options exercised during the three months ended March 31, 2010 and 2009 was \$6.3 million and \$0.7 million, respectively. Net cash proceeds from the exercise of stock options were \$4.0 million for the three months ended March 31, 2010 and \$0.6 million for the three months ended March 31, 2009. At March 31, 2010, unamortized compensation expense related to unvested options was approximately \$14.6 million. The weighted average period over which compensation expense related to these options will be recognized is approximately 2.3 years.

The employee stock-based compensation expense recognized under ASC 718-10-30 *Compensation – Stock Compensation - Overall - Initial Measurement*, was determined using the Black-Scholes option pricing model. Option pricing models require the input of subjective assumptions and these assumptions can vary over time. The Company used the following weighted-average assumptions to determine the fair values of stock option awards granted during the three months ended March 31, 2010 and 2009:

	Three months ended March 31,	
	2010	2009
Expected term (years)	4.1	4.1
Expected volatility	56.3%	60.7%
Risk-free interest rate	1.9%	1.5%
Dividend yield	—	—

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

Restricted Stock

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 per share. The repurchase right expires over a 48 month period as the restricted stock award vests. A summary of the Company's restricted stock awards is presented in the table below:

	Restricted Stock Awards	Weighted Average Grant Date Fair Value Per Share	Weighted Average Remaining Recognition Period (Years)
Outstanding at December 31, 2009	6,550	\$ 16.62	0.14
Awards released	(6,250)	16.54	
Outstanding at March 31, 2010	300	\$ 18.27	0.08

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MONOLITHIC POWER SYSTEMS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Continued) (Unaudited)

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

	<u>Restricted Stock Units</u>	<u>Weighted Average Grant Date Fair Value Per Share</u>	<u>Weighted Average Remaining Recognition Period (Years)</u>
Outstanding at December 31, 2009	289,896	\$ 18.67	2.22
Awards granted	669,340	20.53	
Awards released	(50,571)	15.22	
Awards forfeited	(1,000)	21.25	
Outstanding at March 31, 2010	907,665	\$ 20.23	3.23

The total fair value of restricted stock awards and units that vested was \$1.0 million for the three months ended March 31, 2010 and \$0.7 million for the three months ended March 31, 2009, respectively. The intrinsic value related to restricted stock awards and units released for each of the three months ended March 31, 2010 and 2009 was \$1.2 million. The intrinsic value related to restricted stock awards and units outstanding at March 31, 2010 and 2009 was \$20.2 million and \$5.8 million, respectively. At March 31, 2010, the unamortized compensation expense related to unvested restricted stock awards and units was approximately \$13.9 million with a weighted average remaining recognition period of 3.2 years.

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 March 31, 2010 and 2009, 57,240 shares and 83,426 shares, respectively, were issued under the Purchase Plan. The following is a summary of the Purchase Plan and changes during the three months ended March 31, 2010:

Available Shares as of December 31, 2009	2,553,012
2010 Additions to Plan	703,306
2010 Purchases	(57,240)
Available Shares as of March 31, 2010	<u>3,199,078</u>

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MONOLITHIC POWER SYSTEMS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Continued) (Unaudited)

The Purchase Plan is considered compensatory under ASC 718-50-25-2, *Compensation—Stock Compensation—Employee Share Purchase Plans—Recognition*, and is accounted for in accordance with ASC 718-50-30-2 *Compensation—Stock Compensation—Employee Share Purchase Plans—Initial Measurement—Look-Back Plans*. The intrinsic value for stock purchased was \$0.2 million for each of the three months ended March 31, 2010 and 2009. The unamortized expense as of March 31, 2010 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 months ended March 31, 2010 and 2009, the following weighted average assumptions were used in the valuation of the stock purchase rights:

	<u>Three months ended March 31,</u>	
	<u>2010</u>	<u>2009</u>
Expected term (years)	0.5	0.5
Expected volatility	41.3%	88.7%
Risk-free interest rate	0.2%	0.5%
Dividend yield	—	—

Cash proceeds from employee stock purchases for the three months ended March 31, 2010 and 2009 was \$1.1 million and \$0.9 million, respectively.

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

	<u>March 31, 2010</u>	<u>December 31, 2009</u>
Work in progress	\$ 7,807	\$ 11,082
Finished goods	6,743	8,534
Total inventories	<u>\$ 14,550</u>	<u>\$ 19,616</u>

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

	<u>March 31, 2010</u>	<u>December 31, 2009</u>
Deferred revenue and customer prepayments	\$ 1,976	\$ 2,109
Legal expenses and settlement costs	1,961	2,940
Stock rotation reserve	806	864
Warranty	389	294
Professional fees	71	24
Other	2,090	1,450
Total accrued liabilities	<u>\$ 7,293</u>	<u>\$ 7,681</u>

A summary of the warranty reserve at March 31, 2010 and changes during the three months then ended is presented in the table below (in thousands):

	<u>Three months ended March 31,</u>	
	<u>2010</u>	<u>2009</u>
Balance at beginning of year	\$ 294	\$ 764
Reserve adjustments and unused warranty provision	(26)	(96)
Warranty provision for product sales	121	70
Balance at March 31, 2010	<u>\$ 389</u>	<u>\$ 738</u>

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MONOLITHIC POWER SYSTEMS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Continued) (Unaudited)

5. Net Income (Loss) per Share and Comprehensive Income and Loss — Basic and diluted net income (loss) per share excludes dilution and is computed by dividing net income (loss) by the weighted average number of common shares outstanding for the period. Diluted net income per share is calculated using the treasury stock method and reflects the potential dilution that would occur if outstanding securities or other contracts to issue common stock were exercised or converted into common stock. For the three months ended March 31, 2010 and 2009, the Company had securities outstanding, which could potentially dilute basic net income per share in the future, but were excluded from the computation of diluted net income per share in the periods presented, as their effect would have been anti-dilutive. The following table shows the number of shares of common stock issuable upon conversion or exercise of such outstanding stock options:

	<u>Three months ended March 31,</u>	
	<u>2010</u>	<u>2009</u>
Stock Options	1,506,316	9,380,801
Restricted Stock	—	232,142
ESPP	—	47,323
Total	<u>1,506,316</u>	<u>9,660,266</u>

The following table sets forth the components of other comprehensive income (loss), net of income tax effect (in thousands):

	<u>Three months ended March 31,</u>	
	<u>2010</u>	<u>2009</u>
Net income (loss)	\$ 6,356	\$ (728)
Other comprehensive income (loss):		
Change in value of temporary impairment of auction-rate securities	185	(85)
Unrealized gain (loss) on available-for-sale securities	48	(72)
Foreign currency translation adjustments	1	(26)
Comprehensive income (loss)	<u>\$ 6,590</u>	<u>\$ (911)</u>

6. Segment Information

As defined by the requirements of ASC 280-10-50 *Segment Reporting – Overall – Disclosure*, the Company operates in one reportable segment: the design, development, marketing and sale of high-performance, mixed-signal analog semiconductors for the communications, computing, consumer, and industrial and automotive markets. Geographic revenue is based on the location to which customer shipments are delivered. For the three months ended March 31, 2010, 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 months ended March 31, 2010 and 2009.

<u>Customers</u>	<u>Three months ended March 31,</u>	
	<u>2010</u>	<u>2009</u>
A	14%	*
B	11%	13%
C	10%	15%
D	*	10%

(*) represents less than 10%

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MONOLITHIC POWER SYSTEMS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Continued) (Unaudited)

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

<u>Country</u>	<u>Three months ended March 31,</u>	
	<u>2010</u>	<u>2009</u>
China	\$ 22,565	\$ 10,469
Korea	8,511	7,279
Taiwan	5,515	3,230
Europe	5,460	4,346
Japan	2,880	1,841
USA	2,843	1,287
Other	2,476	870
Total	<u>\$ 50,250</u>	<u>\$ 29,322</u>

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

<u>Product Family</u>	<u>Three months ended March 31,</u>	
	<u>2010</u>	<u>2009</u>
DC to DC Converters	\$ 40,301	\$ 21,152
Lighting Control Products	7,434	4,686
Audio Amplifiers	2,515	3,484
Total	<u>\$ 50,250</u>	<u>\$ 29,322</u>

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

	<u>March 31, 2010</u>	<u>December 31, 2009</u>
China	\$ 18,865	\$ 15,440
United States	2,762	2,484
Japan	86	75
Taiwan	77	75
Other	45	34
TOTAL	<u>\$ 21,835</u>	<u>\$ 18,108</u>

7. Litigation

O2Micro

The Company has been engaged in a number of legal proceedings involving patent infringement claims with O2Micro, Inc. and its parent corporation, O2Micro International Limited (referred to hereinafter as "O2Micro"). Currently there are two proceedings pending, both involving O2 Micro's U.S. Patent No. 7,417,382 ('382 patent). On April 20, 2010, the Administrative Law Judge (ALJ) overseeing the U.S. International Trade Commission issued an initial determination (ID) finding that none of MPS's products accused by O2 Micro infringes the '382 patent. The ALJ's ID can be reviewed by the full Commission. The Commission's final determination is expected to be issued by August 20, 2010.

In addition to the matter before the ITC, a related case is pending before the Northern District of California Court in Oakland, California. On October 1, 2008, MPS brought an action in the Northern District Court seeking a declaratory judgment that none of its products infringed the '382 patent, among others and the patent is invalid. O2 Micro brought a counterclaim alleging that MPS's products infringed the '382 patent, among others. O2 Micro then withdrew its infringement claims as to the other patents except the '382 patent. The Northern District Court action is scheduled for trial on July 12, 2010. O2 Micro seeks damages and an injunction in connection with that action. MPS is not able to reasonably estimate the probability of loss or the range of possible loss in this case.

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MONOLITHIC POWER SYSTEMS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Continued) (Unaudited)

Linear Technology Corporation

On July 1, 2008, the United States District Court for the District of Delaware held as a matter of law that the Company did not breach its October 1, 2005 Settlement and License Agreement with Linear Technology Corporation (“Linear”). Based upon that ruling, the Company anticipates filing a motion to seek recovery of its attorney fees when the final judgment is entered. The court has not issued its final judgment concerning the patent validity and enforceability issues.

8. Fair Value Measurements

The Company adopted the provisions of ASC 820-10 *Fair Value Measurements and Disclosures – Overall*, which 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 Company also adopted the provisions of ASC 820-10-35-51 *Fair Value Measurement and Disclosure – Overall – Subsequent Measurement – Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly*, effective April 1, 2009, which provides additional guidance for estimating fair value in accordance with ASC 820-10 *Fair Value Measurements and Disclosures – Overall*, when the volume and level of activity for the asset or liability have significantly decreased. Effective January 1, 2010, the Company adopted the provisions of ASU 2010-06, “*Disclosures About Fair Value Measurements*”, which adds new requirements for disclosures about transfers into and out of Levels 1 and 2 and separate disclosures about purchases, sales, issuances, and settlements relating to Level 3 measurements.

The following table details the fair value measurements as of March 31, 2010 within the fair value hierarchy of the financial assets that are required to be recorded at fair value (in thousands):

	Fair Value Measurements at March 31, 2010 Using			
		Quoted Prices in Active Markets for Identical Assets	Significant Other Observable Inputs	Significant Unobservable Inputs
	Total	Level 1	Level 2	Level 3
Government Agencies/Treasuries	\$112,024	\$ 112,024	\$ —	\$ —
Long-term available-for-sale auction-rate securities	19,555	—	—	19,555
Short-term trading auction-rate securities	16,135	—	—	16,135
Put right	565	—	—	565
	<u>\$148,279</u>	<u>\$ 112,024</u>	<u>\$ —</u>	<u>\$ 36,255</u>

At March 31, 2010, the Company had \$112.0 million in US government agencies and treasuries, \$110.0 million of which are classified as short-term investments and \$2.0 million are classified as cash equivalents on the Condensed Consolidated Balance Sheet. At March 31, 2010, there was \$22,000 in unrealized losses from these investments. The impact of gross unrealized gains and losses was not material.

At March 31, 2010, the Company had \$14.6 million invested in money market funds.

[Table of Contents](#)**MONOLITHIC POWER SYSTEMS, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****(Continued) (Unaudited)**

The face value of the Company's holdings in auction rate securities is \$37.2 million, of which \$20.5 million is currently classified as long-term available-for-sale investments and \$16.7 million is classified as short-term trading investments. The securities that are classified as short-term trading securities have been classified as such because the Company intends to exercise its put option to sell these securities to UBS in June of 2010 (see below). These investments are accounted for in accordance with ASC 320-10, *Investments – Debt and Equity Securities – Overall*.

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

The following 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):

	<u>Auction-Rate Securities</u>	<u>Put Right</u>	<u>Total</u>
Ending balances at December 31, 2009	\$ 35,570	\$ 725	\$36,295
Sales and Settlement	(225)	—	(225)
Unrealized Gain	185	—	185
Gain (loss) from UBS auction rate securities and put right	160	(160)	—
Ending balances at March 31, 2010	<u>\$ 35,690</u>	<u>\$ 565</u>	<u>\$36,255</u>

The Company's Level 3 assets consist of government-backed student loan auction-rate securities and the UBS put right described below. The market for auction-rate securities, with interest rates that reset through a Dutch auction every 7 to 35 days became illiquid in 2008. As of March 31, 2010, the Company's investment portfolio included \$35.7 million, net of impairment charges of \$1.5 million, in government-backed student loan auction-rate securities. The portfolio also included a UBS auction-rate put right, which was valued at \$0.6 million in accordance with the fair value measurement provisions of ASC 825-10-25 *Financial Instruments – Overall – Recognition*. During the three months ended March 31, 2010, auction rate securities with a face value of \$0.2 million were sold at par through successful auctions. However, the remaining auction rate securities in the portfolio with a face value of approximately \$37.2 million 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 38 years and the underlying credit quality of these instruments in which the Company has invested remain generally AAA rated, with \$11.9 million in auction rate securities having been downgraded by Moody's to Aa1-Baa3.

In October 2008, the Company accepted an offer to participate in an auction-rate security rights offering from UBS to sell up to \$18.2 million in face value of eligible auction-rate securities commencing in June 2010. Since then, \$1.5 million of these auction-rate securities were called at par, leaving \$16.7 million in eligible auction-rate securities remaining at UBS. The offer gives the Company the right but not the obligation to sell these securities at par to UBS and allows the Company to borrow up to \$16.7 million, if needed. In accepting the offer, the Company also entered into a release of claims in favor of UBS.

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MONOLITHIC POWER SYSTEMS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Continued) (Unaudited)

Since the Company accepted this put right from UBS in October 2008, the Company classified these as trading securities, and as such, intends to sell these auction-rate securities at par to UBS commencing in June 2010, for which the proceeds from the sale will be received in July 2010. The cumulative impairment related to these auction-rate securities was \$0.6 million and \$0.7 million at March 31, 2010 and December 31, 2009, respectively. The change in the impairment was recorded in accordance with the provisions of ASC 320-10-35 and ASC 320-10-50 in other income (expense) in the Condensed Consolidated Statement of Operations.

Having accepted UBS' rights offering and elected the fair value option under ASC 820-10-35, the Company valued the resulting put right at fair value which was estimated to be equal to the par value of the auction-rate securities less their fair value as determined by management. The value of the put right was \$0.6 million and \$0.7 million, at March 31, 2010 and December 31, 2009, respectively. The change in the value of the put right has been recorded by the Company in other income (expense) in the Condensed Consolidated Statement of Operations.

For the remaining auction-rate securities for which the put right (described above) does not apply, and which have a face value of \$20.5 million and \$20.5 million as of March 31, 2010 and December 31, 2009, respectively, management concluded that as of March 31, 2010 and December 31, 2009, the cumulative impairment of \$0.9 million and \$1.1 million, respectively, was temporary based on the following analysis:

- The decline in the fair value of these securities is not largely attributable to adverse conditions specifically related to these securities or to specific conditions in an industry or in a geographic area;
- Management possesses both the intent and ability to hold these securities for a period of time sufficient to allow for any anticipated recovery in fair value;
- Management believes that it is more likely than not that the Company will not have to sell these securities before recovery of its cost basis;
- Except for the credit loss of \$70,000 recognized during the year ended December 31, 2009 for the Company's holdings in auction rate securities described below, the Company does not believe that there is any additional credit loss associated with other auction-rate securities because the Company expects to recover the entire amortized cost basis;
- The majority of the securities remain AAA rated, with \$8.9 million of the auction rate securities having been downgraded by Moody's to A3-Baa3, during the year ended December 31, 2009 and there have been no downgrades in the three months ended March 31, 2010; and
- All scheduled interest payments have been made pursuant to the reset terms and conditions.

Based on the guidance of ASC 320-10-35 and ASC 320-10-50, the Company evaluated the potential credit loss of each of the auction-rate securities for which a put right was not provided. Based on such analysis, the Company determined that those securities that are not 100% FFELPS guaranteed are potentially subject to credit risks based on the extent to which the underlying debt is collateralized and the security-specific student-loan default rates. MPS' portfolio includes three such securities, one of which has a senior parity ratio of approximately 115%, which is substantially above the expected student-loan default rate for that security. Conversely, the senior parity ratio for the other two securities is approximately 105%. If, therefore, the student-loan default rate and borrowing rate for these issuers increases, the remaining balance in these trusts may not be sufficient to cover the senior debt. The Company therefore concluded that there is potential credit risk for these two securities and as such, used the discounted cash flow model to determine the amount of credit loss to be recorded. In valuing the potential credit loss, the following parameters were used: 20 year expected term, cash flows based on the 90-day t-bill rates for 20 year forwards and a risk premium of 5.9%, the amount of interest that the Company was receiving on these securities when the market was last active. As of March 31, 2010 and December 31, 2009, the potential credit loss associated with these securities was \$70,000, which the Company deemed other-than-temporarily impaired and recorded in other expense in its Condensed Consolidated Statement of Operations during 2009.

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

MONOLITHIC POWER SYSTEMS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Continued) (Unaudited)

The valuation of the auction-rate securities is subject to fluctuations in the future, which will depend on many factors, including the collateral quality, potential to be called or restructured, underlying final maturity, insurance guaranty, liquidity and market conditions, among others. To determine the fair value of the auction-rate securities at March 31, 2010 and December 31, 2009, the Company used a discounted cash flow model, for which there are three valuation parameters, including time-to-liquidity, discount rate and expected return. The following are the values used in the discounted cash flow model:

	<u>December 31, 2009</u>	<u>March 31, 2010</u>
Time-to-Liquidity	24months	24months
Expected Return (Based on the 2-year treasury rate, plus a contractual penalty rate)	2.4%	2.4%
Discount Rate (Based on the 2-year LIBOR, the cost of debt and a liquidity risk premium)	5.2% -10.0%, depending on the credit-rating of the security	4.6% -9.4%, depending on the credit-rating of the security

The gross accumulated impairment charge was \$1.5 million as of March 31, 2010, of which \$0.9 million was recorded as temporary and the remaining \$0.6 million was recorded as other-than-temporary. The gross accumulated impairment charge was \$1.8 million as of December 31, 2009, of which \$1.1 million was recorded as temporary and the remaining \$0.7 million was recorded as other-than-temporary.

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

9. Income Taxes

The income tax provision for the three months ended March 31, 2010 was \$0.3 million or 4.3% of our income before income taxes. This differs from the federal statutory rate of 34% primarily because our foreign income is taxed at lower rates. The income tax provision for the three months ended March 31, 2009 was \$0.1 million or 7.7% of our income before income taxes. This differed from the federal statutory rate of 34% primarily because our foreign income was taxed at lower rates.

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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 and families,*
- *our belief that we will continue to incur significant legal expenses that vary with the level of activity in each of our legal proceedings,*
- *the impact of our outstanding litigation and changing market conditions on the revenue we derive from our CCFL product line,*
- *the effect of auction-rate securities on our liquidity and capital resources,*
- *the application of our products in the computer, consumer electronics, and communications markets continuing to account for a majority of our revenue,*
- *estimates of our future liquidity requirements,*
- *the cyclical nature of the semiconductor industry,*
- *protection of our proprietary technology,*
- *near term business outlook for 2010,*
- *the factors that we believe will impact our ability to achieve revenue growth,*
- *the percentage of our total revenue from various market segments, and*
- *the factors that differentiate us from our competitors.*

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.

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 flat panel televisions, wireless communications, telecommunications equipment, general consumer products, notebook computers, cellular handsets, and set top boxes, among others. We believe that we differentiate ourselves by offering solutions that are more highly integrated, smaller in size, more energy efficient, more accurate with respect to performance specifications and, consequently, more cost-effective than many competing solutions. We plan to continue to introduce 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. We are not and will not be immune from current and future industry downturns, but we have targeted product and market areas that we believe have the ability to offer above average industry performance over the long term.

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

Generally, it is difficult for us to forecast revenue for the following reasons:

- Orders in the semiconductor industry can be cancelled or rescheduled without significant penalty to the customer. This is mitigated to a certain extent, as the typical lead times for our orders are fewer than 90 days.

- We are not able to predict, with certainty, the sales cycle for new products to gain traction in the market. Generally, it takes six to twelve months to achieve revenue, with volume production achieved three to six months after we receive an initial customer order for a new product.

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. 83% of our revenue for the quarter ended March 31, 2010 and 80% of our revenue for the quarter ended March 31, 2009 was attributable to direct or indirect sales to customers in Asia. We derive a majority of our revenue from the sales of our DC to DC converter product family which services the consumer electronics, communications and computing 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.

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Critical Accounting Policies and Estimates

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

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

Revenue Recognition. We recognize revenue in accordance with Financial Accounting Standards Board (“FASB”) – Accounting Standards Codification (“ASC”) 605-10-S25 *Revenue Recognition – Overall – Recognition*. ASC 605-10-S25 requires that four basic criteria must be met before revenue can be recognized: (1) persuasive evidence of an arrangement exists; (2) delivery has occurred or services have been rendered; (3) the fee is fixed 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.

Approximately 90% of our distributor sales are made through distribution arrangements with third parties. These arrangements do not include any special payment terms (our normal payment terms are 30-45 days), price protection or exchange rights. Returns are limited to our standard product warranty. Certain of our large distributors have contracts that include limited stock rotation rights that permit the return of a small percentage of the previous six months’ purchases in return for a compensating new order of equal or greater dollar value.

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

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

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

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

Approximately 10% of our distributor sales are made through small distributors based on purchase orders rather than formal distribution arrangements. These distributors do not receive any stock rotation rights and, as such, hold very little inventory, if any. We do not have a history of accepting returns from these distributors.

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

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. The deferred revenue balance from this distributor as of March 31, 2010 and December 31, 2009 was \$0.3 million and \$0.9 million, respectively.

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

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

Accounting for Income Taxes. ASC 740-10 *Income Taxes – Overall* prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods and disclosure. In accordance with ASC 740-10, we recognize federal, state and foreign current tax liabilities or assets based on our estimate of taxes payable or refundable in the current fiscal year by tax jurisdiction. We also recognize federal, state and foreign deferred tax assets or liabilities for our estimate of future tax effects attributable to temporary differences and carryforwards. We record a valuation allowance to reduce any deferred tax assets by the amount of any tax benefits that, based on available evidence and judgment, are not expected to be realized.

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

As of March 31, 2010 and December 31, 2009, we had a valuation allowance of \$14.6 million and \$14.6 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 valuation allowance for the deferred tax asset would increase income in the period such determination was made.

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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 ASC 450-20-25-2 *Contingencies – Loss Contingencies—Recognition* to determine whether a contingent liability should be recorded. In making this determination, management may, depending on the nature of the matter, consult with internal and external legal counsel and technical experts. Based on the facts and circumstances in each matter, we use our judgment to determine whether it is probable that a contingent loss has occurred and whether the amount of such loss can be estimated. If we determine a loss is probable and estimable, we record a contingent loss in accordance with ASC 450-20-25-2. In determining the amount of a contingent loss, we take into account advice received from experts for each specific matter regarding the status of legal proceedings, settlement negotiations (which may be ongoing), prior case history and other factors. Should the judgments and estimates made by management need to be adjusted as additional information becomes available, we may need to record additional contingent losses that could materially and adversely impact our results of operations. Alternatively, if the judgments and estimates made by management are adjusted, for example, if a particular contingent loss does not occur, the contingent loss recorded would be reversed which could result in a favorable impact on our results of operations.

Accounting for Stock-Based Compensation. We have adopted the provisions of ASC 718-10-30 *Compensation – Stock Compensation – Overall – Initial Measurement*, under the modified prospective method. ASC 718-10-30 eliminates the alternative of applying the intrinsic value measurement 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 during which an employee is required to provide services in exchange for the award, known as the requisite service period (usually the vesting period). We currently use the Black-Scholes option-pricing model to estimate the fair value of our share-based payments. The Black-Scholes option-pricing model is based on a number of assumptions, including historical volatility, expected life, risk-free interest rate and expected dividends. 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.

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

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

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

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

The face value of our holdings in auction rate securities is \$37.2 million, of which \$20.5 million is currently classified as long-term available-for-sale investments and \$16.7 million is classified as short-term trading investments. The securities that are classified as short-term trading securities have been classified as such because the Company intends to exercise its put option to sell these securities to UBS in June of 2010. These investments are accounted for in accordance with ASC 320-10, *Investments – Debt and Equity Securities – Overall*. Investments in available-for-sale securities are recorded at fair value, and unrealized gains or losses (that are deemed to be temporary) are recognized through shareholders' equity, as a component of accumulated other comprehensive income in our consolidated balance sheet. We record an impairment charge to earnings when an available-for-sale investment has experienced a decline in value that is deemed to be other-than-temporary. Investments in trading securities are recorded at fair value and unrealized gains and losses are recognized in other income (expense) in our condensed consolidated statement of operations.

We adopted the provisions of ASC 320-10-35 *Investments – Debt and Equity Securities – Overall – Subsequent Measurement* and ASC 320-10-50 *Investments – Debt and Equity Securities – Overall – Disclosure*, effective April 1, 2009 and used the guidelines therein to determine whether the impairment is temporary or other-than temporary. Other-than-temporary impairment charges exists when the entity