

MICROTUNE INC
Form 10-Q
January 22, 2007
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-Q

(Mark one)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2006

OR

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

Commission file number 000-31029-40

MICROTUNE, INC.

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of
Incorporation or organization)

2201 10th Street
Plano, Texas 75074

75-2883117
(I.R.S. Employer
Identification Number)

Edgar Filing: MICROTUNE INC - Form 10-Q

(Address of principal executive office and zip code)

(972) 673-1600

(Registrant's telephone number, including area code)

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

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

Large accelerated filer Accelerated filer Non-accelerated filer

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

As of January 15, 2007, there were approximately 53,290,164 shares of the Registrant's Common Stock, \$0.001 par value per share outstanding.

Table of Contents

MICROTUNE, INC.

FORM 10-Q

September 30, 2006

INDEX

	Page
<u>Part I. FINANCIAL INFORMATION</u>	
Item 1. <u>Financial Statements.</u>	3
<u>Consolidated Balance Sheets at September 30, 2006 and December 31, 2005 (unaudited)</u>	3
<u>Consolidated Statements of Operations for the Three and Nine Months Ended September 30, 2006 and 2005 (unaudited)</u>	4
<u>Consolidated Statements of Cash Flows for the Nine Months Ended September 30, 2006 and 2005 (unaudited)</u>	5
<u>Notes to Consolidated Financial Statements (unaudited)</u>	6
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations.</u>	23
Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk.</u>	43
Item 4. <u>Controls and Procedures.</u>	43
<u>Part II. OTHER INFORMATION</u>	
Item 1. <u>Legal Proceedings.</u>	44
Item 1A. <u>Risk Factors.</u>	44
Item 6. <u>Exhibits.</u>	48
<u>Signatures</u>	50

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

	September 30,	December 31,
	2006	2005
Assets		
Current assets:		
Cash and cash equivalents	\$ 19,602	\$ 5,068
Short-term investments	62,773	77,120
Accounts receivable, net	7,637	5,911
Inventories	9,134	7,944
Other current assets	2,339	1,293
Total current assets	101,485	97,336
Property and equipment, net	4,208	4,398
Other assets and deferred charges	1,121	1,587
Total assets	\$ 106,814	\$ 103,321
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	\$ 3,894	\$ 5,414
Accrued compensation	2,265	1,769
Accrued expenses	2,139	1,651
Deferred revenue	62	8
Total current liabilities	8,360	8,842
Other non-current liabilities	57	54
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, \$0.001 par value		
Authorized 25,000 shares		
Issued and outstanding shares none		
Common stock, \$0.001 par value		
Authorized 150,000 shares		
Issued and outstanding shares 53,274 and 52,761, respectively	53	53
Additional paid-in capital	453,317	448,726
Unearned stock compensation		(1,105)
Accumulated other comprehensive loss	(990)	(1,013)
Accumulated deficit	(353,983)	(352,236)

Edgar Filing: MICROTUNE INC - Form 10-Q

Total stockholders' equity	98,397	94,425
Total liabilities and stockholders' equity	\$ 106,814	\$ 103,321

See accompanying notes.

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

	Three Months Ended		Nine Months Ended	
	September 30, 2006	September 30, 2005	September 30, 2006	September 30, 2005
Net revenue	\$ 17,965	\$ 16,351	\$ 52,660	\$ 42,019
Cost of revenue	9,071	8,201	26,100	19,801
Gross margin	8,894	8,150	26,560	22,218
Operating expenses:				
Research and development	5,172	4,083	15,316	12,173
Selling, general and administrative	6,331	3,897	15,997	12,361
Amortization of intangible assets		660		2,008
Total operating expenses	11,503	8,640	31,313	26,542
Loss from operations	(2,609)	(490)	(4,753)	(4,324)
Other income (expense):				
Interest income	1,117	662	3,024	1,750
Foreign currency gains (losses), net	(38)	6	113	(211)
Other	4	4	31	93
Income (loss) before provision for income taxes	(1,526)	182	(1,585)	(2,692)
Income tax expense (benefit)	3	72	162	94
Net income (loss)	\$ (1,529)	\$ 110	\$ (1,747)	\$ (2,786)
Net income (loss) per common share:				
Basic	\$ (0.03)	\$ 0.00	\$ (0.03)	\$ (0.05)
Diluted	\$ (0.03)	\$ 0.00	\$ (0.03)	\$ (0.05)
Weighted-average common shares outstanding:				
Basic	53,249	52,341	53,055	52,148
Diluted	53,249	56,814	53,055	52,148

See accompanying notes.

Net income for the third quarter and first three quarters of 2006 included stock-based compensation expense under SFAS No. 123(R) of approximately \$1.7 million and \$4.6 million, respectively. See Note 1.

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

	Nine Months Ended	
	September 30,	
	2006	2005
Operating activities:		
Net loss	\$ (1,747)	\$ (2,786)
Adjustments to reconcile net loss to cash used in operating activities:		
Depreciation	1,141	1,474
Amortization of intangible assets		2,008
Foreign currency (gains) losses, net	(113)	211
Stock-based compensation	4,584	606
Loss (gain) on sale of assets	3	(45)
Changes in operating assets and liabilities:		
Accounts receivable, net	(1,726)	(1,553)
Inventories	(1,190)	571
Other assets	(580)	(1,369)
Accounts payable	(1,520)	(510)
Accrued expenses	542	(1,094)
Accrued compensation	496	27
Other liabilities	3	
Net cash used in operating activities	(107)	(2,460)
Investing activities:		
Purchases of property and equipment	(961)	(447)
Proceeds from sale of assets	7	58
Proceeds from maturity of held-to-maturity investments	1,620	
Proceeds from sale of available-for-sale investments	47,600	33,800
Purchase of available-for-sale investments	(34,850)	(59,300)
Net cash provided by (used in) investing activities	13,416	(25,889)
Financing activities:		
Proceeds from issuance of common stock	1,112	746
Net cash provided by financing activities	1,112	746
Effect of foreign currency exchange rate changes on cash	113	(211)
Net increase (decrease) in cash and cash equivalents	14,534	(27,814)
Cash and cash equivalents at beginning of period	5,068	34,515
Cash and cash equivalents at end of period	\$ 19,602	\$ 6,701

See accompanying notes.

Table of Contents

MICROTUNE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2006

(unaudited)

1. Summary of Significant Accounting Policies

Description of business

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

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

General

The accompanying unaudited financial statements as of and for the third quarter and first three quarters of 2006 and 2005 have been prepared by us, pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States (GAAP) have been condensed or omitted pursuant to such rules and regulations. These unaudited consolidated financial statements should be read in conjunction with the audited financial statements and the notes thereto included in our Amended Annual Report on Form 10-K/A for the fiscal year ended December 31, 2005 filed simultaneously with this report on January 22, 2007.

In the opinion of management, all adjustments which are of a normal and recurring nature and are necessary for a fair presentation of the financial position, results of operations, and cash flows as of and for the third quarter and first three quarters of 2006 and 2005 have been made. Results of operations for the third quarter and first three quarters of 2006 and 2005 are not necessarily indicative of results of operations to be expected for the entire year or any other period.

Risk and Uncertainties

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

Consolidation

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

Use of Estimates

We make estimates, judgments and assumptions that affect the amounts reported in the financial statements and the disclosures made in the accompanying notes, including inventory valuation allowances, warranty costs, determining the collectibility of accounts receivable, the valuation of deferred tax assets, contingent liabilities and other amounts. We also use estimates, judgments and assumptions to determine the remaining economic lives and carrying values of purchased intangible assets, property and equipment and other long-lived assets. We believe that the estimates, judgments and assumptions upon

Table of Contents

MICROTUNE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2006

(unaudited)

which we rely are appropriate and correct, based upon information available to us at the time that they are made. These estimates, judgments and assumptions can affect our reported assets and liabilities as of the date of the financial statements, as well as the reported revenue and expenses during the periods presented. If there are material differences between these estimates, judgments or assumptions and actual facts, our financial statements will be affected.

Cash and Cash Equivalents

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

Investments

Our investments are comprised of high-quality securities purchased in accordance with our investment policy. Investments in debt securities are classified as held-to-maturity when we intend to hold them to maturity. Held-to-maturity investments are carried at amortized cost with the amortization of the purchase discount recorded in interest income. Investments in debt securities not classified as held-to-maturity and equity securities are classified as available-for-sale and carried at fair value, with unrealized gains and losses, net of tax, recorded in stockholders equity. Realized gains and losses and other than temporary declines in value, if any, on available-for-sale securities are reported in other income and expense as incurred and are determined based on the specific identification method. At September 30, 2006, our short-term investments, which consist of corporate debt securities and other debt securities issued by United States government and state agencies, including auction-rate securities, included \$57.8 million of available-for-sale investments and \$5.0 million of held-to-maturity investments. The auction-rate securities in established markets are available to support current operations and are classified as short-term investments although their contractual maturities are greater than 10 years. At September 30, 2006, we held no long-term investments. The carrying values of our investments approximate their fair values. Our investments are reviewed periodically for other-than-temporary impairment. At September 30, 2006, the unamortized discounts on our investments were insignificant.

Allowance for Doubtful Accounts

We evaluate the collectibility of our accounts receivable based on several factors. In circumstances where we are aware of a specific customer's inability to meet its financial obligations to us, we record a specific allowance for bad debts against amounts due to us and reduce the net recorded receivable to the amount we reasonably believe will be collected. We also consider recognizing allowances for doubtful accounts based on the length of time the receivables are outstanding compared to contractual terms, industry and geographic concentrations, the current business environment and our historical experience. Accounts receivable included in the allowance for doubtful accounts are written-off after final collection efforts are exhausted. If the financial condition of our customers deteriorates or if economic conditions worsen, increases in the allowance may be required in the future. We cannot predict future changes in the financial stability of our customers, and there can be no assurance that our allowance will be adequate. Actual credit losses for the third quarter and first three quarters of 2006 and 2005 were insignificant. No allowance for doubtful accounts was recorded as of September 30, 2006 and December 31, 2005.

Inventory Valuation

Our inventories are stated at the lower of standard cost, which approximates actual cost, or estimated realizable value. Amounts are removed from inventory using the first-in, first-out (FIFO) method. Adjustments to reduce our inventories to estimated realizable value, including allowances for excess and obsolete inventories, are determined quarterly by comparing inventory levels of individual materials and parts to current demand forecasts for those items. Actual amounts realized upon the sale of inventories may differ from estimates used to determine inventory valuation allowances due to changes in customer demand, technology changes and other factors. The net impact of changes in the inventory valuation allowances for the third quarter of 2006 and 2005 was a charge (benefit) to cost of revenue of approximately \$0.4 million and \$(0.1) million, respectively. The net impact of changes in the inventory valuation allowances for the first three quarters of 2006 was

Edgar Filing: MICROTUNE INC - Form 10-Q

insignificant. The net impact of changes in the inventory valuation allowances for the first three quarters 2005 was a benefit to cost of revenue of approximately \$0.2 million.

Table of Contents

MICROTUNE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2006

(unaudited)

Property and Equipment

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

Intangible Assets

Our intangible assets, which consist primarily of acquired patents and customer base, have been recorded as the result of our business or asset acquisitions. During the third quarter and first three quarters of 2005, the remaining unamortized intangible assets were being amortized on the straight-line basis over 3 years. Amortization expense on intangible assets was \$0.7 million and \$2.0 million for the third quarter and first three quarters of 2005, respectively. No amortization expense on intangible assets was recorded in the third quarter and first three quarters of 2006 as our intangible assets became fully amortized in the quarter ended September 30, 2005.

Impairment of Long-lived Assets

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

Revenue Recognition

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

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

For certain of our customers, we do not recognize revenue until receipt of payment because collection is not probable or the amount we will ultimately collect is not determinable at the date of the shipment. Upon shipment of product to these customers, title to the inventory transfers to the customer and the customer is invoiced. We account for these transactions by recording accounts receivable for the revenue value of the shipments, as the shipments represent valid receivables, and reducing inventory for the cost of the inventory shipped. The difference, representing the gross margin on the transactions, is recorded as deferred revenue. For financial statement presentation purposes, this deferred revenue balance is offset against the corresponding accounts receivable balance from the customer. When payment is received for the transaction, revenue is recognized for the value of the cash payment, cost of revenue is recorded for the cost of the inventory and the deferred revenue is relieved for the gross margin on the transaction. At September 30, 2006 and December 31, 2005, the sales value of products shipped for which revenue was deferred was approximately \$0.1 million and \$0.2 million, respectively. All of the revenue deferred at December 31,

Edgar Filing: MICROTUNE INC - Form 10-Q

2005 was recognized during the first quarter of 2006.

When we defer revenue, the timing and amount of revenue we ultimately recognize is determined upon our receipt of payment, which can result in significant fluctuations in revenue from period to period. In the third quarter of 2006 and 2005, we recognized 1% and 2%, respectively, of our net revenue upon receipt of payment. In the first three quarters of 2006 and 2005, we recognized 5% and 5%, respectively, of our net revenue upon receipt of payment.

Table of Contents

MICROTUNE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2006

(unaudited)

We also defer revenue when customers have made payments and we have not completed the earnings process. These payments are reflected as liabilities in our financial statements as deferred revenue. In these instances, we recognize revenue once the product is shipped, title has transferred to our customer and the earnings process is complete. Deferred revenue as a result of customer prepayments was insignificant as of September 30, 2006 and December 31, 2005.

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

Research and Development Costs

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

Shipping and Handling Costs

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

Warranty Costs

We generally provide a minimum of a one-year warranty on all products. We record specific warranty provisions for any identified individual product issues, which have not been significant to date.

Foreign Currency Translation

Our functional currency is the United States Dollar. The impact from the re-measurement of accounts not denominated in United States Dollars is recognized currently in our results of operations as a component of foreign currency gains and losses and results primarily from exchange rate fluctuations between the United States Dollar and the Euro. Foreign currency gains (losses), net were insignificant during the third quarter of 2006 and 2005. Foreign currency gains (losses), net were \$0.1 million and \$(0.2) million during the first three quarters of 2006 and 2005, respectively.

Income Taxes

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

Edgar Filing: MICROTUNE INC - Form 10-Q

December 31, 2005.

Income (Loss) Per Share

Basic income (loss) per common share is computed by dividing net income (loss) by the weighted average number of common shares outstanding during each period. Diluted income (loss) per common share is computed by dividing net income (loss) by the weighted average number of common shares outstanding during each period and dilutive common equivalent shares consisting of stock options, restricted stock, restricted stock units and employee stock purchase plan options. All potentially dilutive common equivalent shares were anti-dilutive and were excluded from diluted loss per common share for the third quarter of 2006 and first three quarters of 2006 and 2005.

Table of Contents**MICROTUNE, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****September 30, 2006****(unaudited)**

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

	Three Months Ended		Nine Months Ended	
	September 30, 2006	September 30, 2005	September 30, 2006	September 30, 2005
Net income (loss)	\$ (1,529)	\$ 110	\$ (1,747)	\$ (2,786)
Diluted earnings (loss) per common and dilutive potential common share:				
Weighted average common shares outstanding	53,249	52,341	53,055	52,148
Weighted average dilutive potential common shares:				
Stock options		4,401		
Restricted stock units				
Employee stock purchase plan		72		
Weighted average common and dilutive potential common shares	53,249	56,814	53,055	52,148
Diluted income (loss) per common share:	\$ (0.03)	\$ 0.00	\$ (0.03)	\$ (0.05)
Basic income (loss) per common share:	\$ (0.03)	\$ 0.00	\$ (0.03)	\$ (0.05)

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

	Three Months Ended		Nine Months Ended	
	September 30, 2006	September 30, 2005	September 30, 2006	September 30, 2005
Stock options	9,674	232	9,674	9,493
Employee stock purchase plan	81		71	159
Total anti-dilutive securities excluded	9,755	232	9,745	9,652

Table of Contents

MICROTUNE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2006

(unaudited)

Stock-Based Compensation

Prior to January 1, 2006, we elected to follow Accounting Principles Board Opinion (APB) No. 25, *Accounting for Stock Issued to Employees*, and related interpretations to account for our employee and director stock options, as permitted by Statement of Financial Accounting Standards (SFAS) No. 123, *Accounting for Stock-Based Compensation*. We accounted for stock-based compensation for non-employees under the fair value method prescribed by SFAS No. 123. Effective January 1, 2006, we adopted the fair value recognition provisions of SFAS No. 123 (revised 2004), *Share-Based Payments*, (SFAS No. 123(R)) for all share-based payment awards to employees and directors including stock options, restricted stock units and employee stock purchases related to our employee stock purchase plan. In addition, we have applied the provisions of Staff Accounting Bulletin No. 107 (SAB No. 107), issued by the Securities and Exchange Commission, in our adoption of SFAS No. 123(R).

We adopted SFAS No. 123(R) using the modified-prospective-transition method. Under this transition method, stock-based compensation expense recognized after the effective date includes: (1) compensation cost for all share-based payments granted prior to, but not yet vested as of January 1, 2006, based on the measurement date fair value estimate in accordance with the original provisions of SFAS No. 123, and (2) compensation cost for all share-based payments granted subsequent to January 1, 2006, based on the measurement date fair value estimate in accordance with the provisions of SFAS No. 123(R). Results from prior periods have not been restated and do not include the impact of SFAS No. 123(R). Stock-based compensation expense under SFAS No. 123(R) for the third quarter and first three quarters of 2006 was \$1.7 million and \$4.6 million, respectively, relating to employee and director stock options, restricted stock units and our employee stock purchase plan. Stock-based compensation expense under the provisions of APB No. 25 was \$0.3 million and \$0.6 million for the third quarter and first three quarters of 2005, respectively. See Note 9.

Stock-based compensation expense recognized each period is based on the value of the portion of share-based payment awards that is ultimately expected to vest during the period. SFAS No. 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. In our pro forma disclosures required under SFAS No. 123 for periods prior to 2006, we accounted for forfeitures as they occurred.

Upon adoption of SFAS No. 123(R), we elected to use the Black-Scholes-Merton option-pricing formula to value share-based payments granted to employees subsequent to January 1, 2006 and elected to attribute the value of stock-based compensation to expense using the straight-line single option method. These methods were previously used for our pro forma information required under SFAS No. 123.

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

Prior to the adoption of SFAS No. 123(R), all tax benefits of deductions resulting from the exercise of stock options were required to be presented as operating cash flows in the Consolidated Statement of Cash Flows. SFAS No. 123(R) requires the cash flows resulting from the tax benefits resulting from tax deductions in excess of the compensation cost recognized for those options (excess tax benefits) to be classified as financing cash flows. Due to our historical net operating loss position, we have not recorded these excess tax benefits as of September 30, 2006.

Comprehensive Income

Edgar Filing: MICROTUNE INC - Form 10-Q

SFAS No. 130, *Reporting Comprehensive Income*, establishes standards for reporting and displaying comprehensive income and its components in the consolidated financial statements. Accumulated other comprehensive income (loss) at September 30, 2006 includes foreign currency translation adjustments of \$1.0 million and unrealized gains or losses on investments.

Table of Contents

MICROTUNE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2006

(unaudited)

Risk Concentrations

Financial instruments that potentially expose Microtune to concentrations of credit risk consist primarily of trade accounts receivable. At September 30, 2006, approximately 66% of our net accounts receivable were due from five of our customers. We periodically evaluate the creditworthiness of our customers' financial condition and generally do not require collateral. We evaluate the collectibility of our accounts receivable based on several factors. In circumstances when we are aware of a specific customer's inability to meet its financial obligations to us, we record a specific reserve for bad debts against amounts due to us and reduce the net recorded receivable to the amount we reasonably believe will be collected. For all other customers, we recognize allowances for doubtful accounts based on the length of time the receivables are outstanding, industry and geographic concentrations, the current business environment and our historical experience. If the financial condition of our customers deteriorates or if economic conditions worsen, additional allowances may be required in the future. Historically, our bad debts have been insignificant and we are not currently aware of any significant uncollectible accounts. During the third quarter and first three quarters of 2006 and 2005, charges to write off uncollectible accounts were insignificant. As a result, we have not recorded an allowance for doubtful accounts as of September 30, 2006.

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

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

Commitments and Contingencies

We may be subject to the possibility of loss contingencies for various legal matters. Our discussion of legal matters includes pending litigation and matters in which any party has manifested a present intention to commence litigation related to such matters. There can be no assurance that additional contingencies of a legal nature or having legal aspects will not be asserted in the future. Such matters could relate to prior transactions or events or future transactions and events. See Note 8. We regularly evaluate current information available to us to determine whether any provisions for loss should be made. If we ultimately determine that a provision for loss should be made for a legal matter, the provision for loss could have a material and adverse effect on our operating results and financial position.

Our future cash commitments are primarily for long-term facility leases. See Note 8.

2. Restatement of Consolidated Financial Statements

During May 2006, after extensive press coverage regarding the stock option dating practices of other companies, our Board of Directors inquired about our own practices. An initial review of high-level timing and pricing characteristics related to historical equity grants indicated no apparent issues. However, in connection with a proposed annual grant to all employees (originally scheduled to occur in early June 2006), and due to management's concern about the timing of the proposed grant relative to our normal trading black-out schedule, management further examined past stock option grant paperwork for the purpose of understanding past granting trends and discovered potentially problematic documentation. Management communicated its concerns to the Audit Committee in June 2006, and the Audit Committee self-initiated an investigation into our stock option grant practices covering the period from the date of our initial public offering, or IPO, on August 4, 2000 through June 2006. The Audit Committee retained independent legal counsel on or about July 3, 2006. Subsequently, the Audit Committee's

Edgar Filing: MICROTUNE INC - Form 10-Q

independent legal counsel retained an independent accounting firm to provide independent accounting and electronic forensic assistance. Management utilized its regular tax advisors to perform certain tax analysis services. The investigation included the evaluation of all stock option grants from August 4, 2000 through June 30, 2006, which encompassed more than 2,000 individual stock option grants to purchase more than 15 million shares of our common stock.

Table of Contents

MICROTUNE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2006

(unaudited)

The Audit Committee's legal and accounting advisors reviewed thousands of pages of hard copy and electronic documents, captured and analyzed over two million e-mail messages and conducted over 20 formal interviews with current and former employees, officers and directors. Current members of our management team cooperated fully with the Audit Committee's investigation.

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

On December 29, 2006, we announced that the Audit Committee had completed its investigation and had made certain determinations. As a result of the Audit Committee's investigation, we have recorded additional stock-based compensation expense and related tax liabilities for certain stock option grants made during the review period. We have restated our consolidated financial statements for the years ended December 31, 2005, 2004, 2003, 2002, 2001, 2000 and 1999 to correctly account for: (1) improper measurement dates for stock option grants, including those relating to stock option plan administration deficiencies, delays in completing granting actions and paperwork, and mischaracterizations of stock option recipients; (2) modifications to stock option grants; (3) employee stock purchase plan administration deficiencies; (4) stock option grants to non-employees; and (5) related tax liabilities, including those associated with the misclassification of certain stock option grants as incentive stock options, or ISOs, and consequently, the underreporting or withholding of payroll taxes on certain stock option exercises.

See our amended Annual Report on Form 10-K/A for the year ended December 31, 2005 for a discussion of the financial impact of the Audit Committee's findings on our restated consolidated financial statements for the years ended December 31, 2005, 2004 and 2003.

Cost of Restatement and Legal Activities

We have incurred substantial expenses for legal, accounting, tax and other professional services in connection with the Audit Committee's investigation, the preparation of our restated financial statements and related regulatory matters. We have incurred expenses of approximately \$2.9 million through December 31, 2006 related to these matters. We incurred approximately \$1.4 million in the quarter ended September 30, 2006. We expect to continue to incur substantial expenses in connection with these matters. We may be obligated to indemnify and advance legal expenses to certain current and former officers pursuant to the requirements of Delaware law and our indemnification agreements with such current and former officers for legal proceedings related to these matters.

Update Regarding SEC Communications

We have informed the SEC of the Audit Committee's investigation of our stock option grant practices and we intend to cooperate with the SEC in any investigation into this matter.

Stock Option Amendment Agreements with Certain Executive Officers

On December 28, 2006, we entered into Stock Option Amendment Agreements with James A. Fontaine, Chief Executive Officer and President of the Company, Albert H. Taddiken, Chief Operating Officer of the Company, and Robert S. Kirk, Vice President of the Worldwide Sales. The purpose of the agreements was to adjust certain stock option awards held by such executives so that the exercise price of portions of these

Edgar Filing: MICROTUNE INC - Form 10-Q

awards will equal the fair market value of the Company's common stock on the actual accounting measurement date of such awards, in order to eliminate potential tax liabilities facing these employees.

Table of Contents

MICROTUNE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2006

(unaudited)

The agreements for Messrs. Kirk and Taddiken provide compensation to them in 2008 of \$62,804 and \$40,957, respectively, and in 2009 of \$1,152 and \$0, respectively, for the increase in the exercise price of their stock option awards subject to the agreement, provided they each are employed by us on those dates. Mr. Fontaine has declined this cash payment and this is reflected in his agreement.

3. Subsystem Module Manufacturing Partner

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

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

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

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

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

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

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

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

4. Accounts Receivable, net

Edgar Filing: MICROTUNE INC - Form 10-Q

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

	September 30, 2006	December 31, 2005
Gross accounts receivable	\$ 7,724	\$ 6,143
Deferred revenue	(87)	(232)
Accounts receivable, net	\$ 7,637	\$ 5,911

Table of Contents**MICROTUNE, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****September 30, 2006****(unaudited)****5. Inventories**

Inventories consist of the following (in thousands):

	September 30, 2006	December 31, 2005
Finished goods	\$ 5,001	\$ 4,768
Work-in-process	4,045	3,131
Raw materials	88	45
 Total inventory	 \$ 9,134	 \$ 7,944

6. Accrued Expenses

Accrued expenses consist of the following (in thousands):

	September 30, 2006	December 31, 2005
Accrued non-cancelable inventory purchase obligations	\$ 437	\$ 359
Accrued accounting and audit fees	590	364
Accrued legal fees	505	61
Other	607	867
 Total accrued expenses	 \$ 2,139	 \$ 1,651

The accrued non-cancelable inventory purchase obligations relate to non-cancelable orders to subcontractors for inventories determined to be excess compared to current inventory levels and current demand forecasts. See Note 8. The accrued expenses are expected to be paid during the next twelve months.

7. Income Taxes

We have established a valuation allowance to fully reserve our net deferred tax assets at September 30, 2006 and December 31, 2005 due to the uncertainty of the timing and amount of future taxable income. During 2005, we adjusted our deferred tax assets and liabilities based on the completion of certain reconciliations and accordingly recorded a corresponding adjustment to our valuation allowance. For United States federal income tax purposes, at December 31, 2005, we had a net operating loss carryforward of approximately \$169.0 million and an unused research and development credit carryforward of approximately \$4.4 million, that will begin to expire in 2011. A change in ownership, as defined in Section 382 of the Internal Revenue Code, may limit utilization of the United States federal net operating loss and research and development credit carryforwards.

Edgar Filing: MICROTUNE INC - Form 10-Q

In the third quarter and first three quarters of 2006 and 2005, the effective tax rate differed from the 34% statutory corporate tax rate primarily due to permanent differences, mostly foreign currency, remeasurement, changes in valuation allowances and lower foreign tax rates. The provision for taxes during the third quarter and first three quarters of 2006 and 2005 consists of foreign income taxes.

Our income tax returns and those of our subsidiaries are subject to review and examination in the various jurisdictions in which we operate. During the third quarter of 2005, we recorded a provision for income taxes of approximately \$0.1 million relating to certain ongoing foreign reviews and examinations. These foreign reviews and examinations were fully resolved and all tax liabilities were paid during the fourth quarter of 2005 and first quarter of 2006. The tax liabilities paid differed from the previously recorded provision by an insignificant amount.

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

Table of Contents**MICROTUNE, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****September 30, 2006****(unaudited)****8. Commitments and Contingencies***Lease Commitments*

In April 2005, we extended our operating lease for our corporate headquarters in Plano, Texas an additional 10 years reducing the monthly base rent and providing a leasehold improvement allowance. This lease extension also included a brief rent abatement and escalating rent payments and provided for certain rights of early termination with corresponding penalties. Rent expense will be calculated using the straight-line method over the lease term. We lease an administrative, sales and marketing, and research and development facility in Germany under an operating lease with a twenty-two year term, which began in December 1999. We also lease certain other facilities and equipment under operating leases. Future minimum lease payments required under operating leases as of September 30, 2006 are as follows (in thousands):

Year Ending December 31,	
2006	\$ 295
2007	1,055
2008	909
2009	834
2010	830
Thereafter	6,331
	\$ 10,254

Rent expense for the third quarter of 2006 and 2005 was \$0.4 million and \$0.3 million, respectively. Rent expense for the first three quarters of 2006 and 2005 was \$1.0 million and \$0.9 million, respectively.

Purchase Commitments

As of January 15, 2007, we had approximately \$14.2 million of cancelable and non-cancelable purchase commitments outstanding with our vendors. These commitments were entered into in the normal course of business.

Other Commitments

We are currently subject to line down clauses in contracts with certain customers. Such clauses require us to pay financial penalties if our failure to supply product in a timely manner causes the customer to slow down or stop their production. We are also subject to product liability clauses and/or intellectual property indemnification clauses in some of our customer contracts. Such clauses require us to pay financial penalties if we supply defective product, which results in financial damages to the customer, or to indemnify the customer for third-party actions based on the alleged infringement by our products of a third party's intellectual property. As of September 30, 2006, we are unaware of any such claims by any of our customers.

Legal Proceedings

From time to time, we may be involved in routine legal proceedings, as well as demands, claims and threatened litigation that arise in the normal course of our business. The ultimate amount of liability, if any, for any claims of any type (either alone or combined) may materially and adversely affect our financial position, results of operations and liquidity. Moreover, the ultimate outcome of any litigation is uncertain. Any

Edgar Filing: MICROTUNE INC - Form 10-Q

outcome, whether favorable or unfavorable, may materially and adversely affect us due to legal costs and expenses, diversion of management resources and other factors. There can be no assurance that additional contingencies of a legal nature or contingencies having legal aspects will not be asserted against us in the future. Such matters could relate to prior, current or future transactions or events. Except as described below, we are not currently a party to any material litigation.

Intellectual Property Litigation

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

Table of Contents

MICROTUNE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2006

(unaudited)

In October 2003, Broadcom requested that the United States Patent and Trademark Office (USPTO) re-examine certain claims of our U.S. Patent No. 5,737,035 (035 patent) that were previously determined to be valid by a U.S. federal court. The USPTO issued an order granting the re-examination proceeding on January 8, 2004. On September 14, 2004, the USPTO examiner assigned to the re-examination issued an action with respect to the patentability of the 035 patent claims undergoing re-examination, confirming certain claims and rejecting others. We responded to the examiner presenting our arguments that these rejected claims were patentable and should be confirmed. On June 20, 2005, the USPTO examiner issued a final office action, confirming certain claims and rejecting others. We responded numerous times to the USPTO and January 23, 2006, the USPTO issued a replacement final office action. On April 11, 2006, the USPTO issued a Notice of Intent to Issue Ex Parte Reexamination Certificate and on November 7, 2006, the USPTO issued an Ex Parte Reexamination Certificate, terminating the re-examination proceedings.

Initial Public Offering Litigation

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

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

9. Stockholders' Equity

Common Stock

On March 4, 2002, our Board declared a dividend of one right for each share of our common stock issued and outstanding at the close of business on March 16, 2002. One right also attaches to each share of our common stock issued subsequent to March 16, 2002. The rights become exercisable to purchase one one-thousandth of a share of new Series A Preferred Stock (Series A), at \$115.00 per right, when a person or entity acquires 15 percent or more of our common stock or announces a tender offer which could result in such a person or entity owning 15 percent or more of our common stock. Each one one-thousandth of a share of the Series A has terms designed to make it substantially the

Edgar Filing: MICROTUNE INC - Form 10-Q

economic equivalent of one share of our common stock. Prior to a person or entity acquiring 15 percent, the rights can be redeemed for \$0.001 each by action of our Board. Under certain circumstances, if a person or entity acquires 15 percent or more of our common stock, the rights permit our stockholders other than the acquirer to purchase our common stock having a market value of twice the exercise price of the rights, in lieu of the Series A. Alternatively, when the rights become exercisable, the Board may authorize the issuance of one share of our common stock in exchange for each right that is then exercisable. In addition, in

Table of Contents

MICROTUNE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2006

(unaudited)

the event of certain business combinations, the rights permit the purchase of the common stock of an acquirer at a 50 percent discount. Rights held by the acquirer will become null and void in both cases. The rights expire on March 3, 2012. On September 30, 2006, 53,274,435 rights were outstanding.

Stock Option Plans

In August 1996, our Board of Directors and the stockholders approved the 1996 Stock Option Plan that provides for incentive stock options and nonqualified stock options to be granted to key employees, certain directors, and consultants of Microtune. Our Board of Directors or designated committee establishes the terms of each option granted under the 1996 Stock Option Plan. The stock options granted under this plan generally vest over 4 to 5 years and have a maximum contractual life of 10 years. At September 30, 2006, we had no options available for grant and 644,152 options granted and outstanding under the 1996 Stock Option Plan. At September 30, 2006, we had reserved 644,152 shares of common stock for issuance upon exercise of options granted pursuant to the 1996 Stock Option Plan.

In August 2000, we adopted the 2000 Stock Plan. The 2000 Stock Plan, as amended, provides for incentive stock options, nonqualified stock options, restricted stock and restricted stock units to be granted to our employees and consultants. Our Board of Directors or designated committees establish the terms of each option granted under the 2000 Stock Plan. The stock options granted under this plan generally vest over 3 to 5 years and have a maximum contractual life of 10 years. During the second quarter of 2006, our Board of Directors approved an executive bonus program for the year 2006 (2006 Executive Bonus Plan) covering executive officers and providing for bonus compensation, to the extent any such compensation is earned, to be paid exclusively through the performance vesting of restricted stock units under the 2000 Stock Plan. An aggregate of 93,000 restricted stock units were awarded under the 2006 Executive Bonus Plan. The number of total restricted stock units that will ultimately vest and result in the issuance of underlying shares to the executive officers is calculated based on certain scoring factors, as defined in the Plan, including net revenue and adjusted profitability for 2006 and the achievement of certain business goals as of December 31, 2006. The vesting of the restricted stock units will be determined and the issuance of the underlying shares will occur during the first quarter of 2007. Any portion of the restricted stock units that do not vest will immediately be forfeited and returned to the 2000 Stock Plan. At September 30, 2006, we had 2,759,558 shares available for grant and 8,471,873 options and 93,000 restricted stock units granted and outstanding under the 2000 Stock Plan. At September 30, 2006, we had reserved 11,324,431 shares of common stock for issuance upon exercise of options or grant of other equity awards granted pursuant to the 2000 Stock Plan.

In August 2000, we adopted a Directors' Stock Option Plan. The Directors' Plan provides for nonqualified stock options to be granted to non-employee members of the Board of Directors. The stock options granted under this plan generally vest over 2 to 3 years and have a maximum contractual life of 10 years. At September 30, 2006, we had 378,000 options available for grant and 500,750 options granted and outstanding under the Directors' Stock Option Plan. At September 30, 2006, we had reserved 878,750 shares of common stock for issuance upon exercise of options granted pursuant to the Directors' Stock Option Plan.

Table of Contents**MICROTUNE, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****September 30, 2006****(unaudited)**

On November 28, 2001, we assumed the obligations under Transilica's Stock Option Plan. The Transilica Stock Option Plan provided for incentive stock options and nonqualified stock options to be granted to key employees and consultants of Transilica. Their Board of Directors established the terms of each option granted under the Transilica Stock Option Plan at the time of grant. The stock options granted under this plan generally vest over 4 years and have a maximum contractual life of 10 years. At September 30, 2006, we had no options available for grant and 57,650 options granted and outstanding under the Transilica Stock Option Plan. At September 30, 2006, we had reserved 57,650 shares of common stock for issuance upon exercise of options granted pursuant to the Transilica Stock Option Plan.

On November 1, 2006, we temporarily ceased all activities under our 1996 Stock Option Plan, 2000 Stock Plan, Directors' Stock Option Plan and Employee Stock Purchase Plan due to the pending restatement of certain historical financial statements as announced on that date. See Note 2, Restatement of Consolidated Financial Statements. We expect to resume normal activities under these plans once the restatement is complete.

A summary of our stock option activity, excluding restricted stock units, and related information for the year ended December 31, 2005 and the first three quarters of 2006 follows:

	Options Outstanding	
	Number of Shares	Weighted Average
	Exercise Price Per Share	
Balance at December 31, 2004	6,726,862	\$ 2.94
Granted	3,298,260	3.94
Exercised	(519,316)	1.96
Canceled	(251,903)	3.63
Balance at December 31, 2005	9,253,903	\$ 3.33
Granted	952,500	5.82
Exercised	(383,777)	1.94
Canceled	(148,201)	3.41
Balance at September 30, 2006	9,674,425	\$ 3.63

The total intrinsic value of options exercised during the third quarter and first three quarters of 2006 was approximately \$0.2 million and \$1.4 million, respectively. During the third quarter and first three quarters of 2006, there were no grants to non-employees.

The following presents certain information about outstanding stock options, excluding restricted stock units, at September 30, 2006 (in thousands, except years and per share data):

Range of	Number	Options Outstanding	Weighted	Aggregate	Number	Options Exercisable	Aggregate
Exercise Price		Weighted Average	Average	Intrinsic		Weighted	Intrinsic
		Remaining	Exercise Price			Average	
						Exercise Price	

Edgar Filing: MICROTUNE INC - Form 10-Q

		Contractual Life			Value		Value		Value
		(Years)							
\$ 0.13 - \$ 0.20	26,167	1.01	\$	0.15	\$ 123	26,167	\$	0.15	\$ 123
\$ 0.38 - \$ 0.88	518,450	3.19		0.82	2,095	518,450		0.82	2,095
\$ 1.25 - \$ 1.85	155,587	4.9		1.52	520	128,554		1.52	429
\$ 1.94 - \$ 2.85	3,168,526	6.9		2.47	7,573	2,378,991		2.46	5,710
\$ 2.92 - \$ 4.35	3,377,447	8.5		3.77	3,681	624,044		3.56	811
\$ 4.47 - \$ 6.64	2,254,081	8.5		5.21		505,396		4.85	5
\$ 7.75 - \$10.40	65,067	4.7		9.30		65,067		9.30	
\$ 12.35 - \$15.45	106,100	4.8		13.81		103,467		13.83	
\$ 26.52 - \$37.88	3,000	4.1		28.41		3,000		28.41	
\$ 0.13 - \$37.88	9,674,425	7.5	\$	3.63	\$ 13,992	4,353,136	\$	3.05	\$ 9,173

The aggregate intrinsic value in the table above is based on the closing price of our common stock of \$4.86 as of September 30, 2006.

Table of Contents**MICROTUNE, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****September 30, 2006****(unaudited)***Employee Stock Purchase Plan*

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

See Note 2 for a discussion of the Audit Committee's independent investigation into our stock plan grant practices.

Stock-based Compensation

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

	Three Months Ended		Nine Months Ended	
	September 30, 2006	September 30, 2005	September 30, 2006	September 30, 2005
Cost of revenue	\$ 14	\$	\$ 39	\$
Research and development	672		1,903	
Selling, general and administrative	976		2,632	
Total stock-based compensation expense included in operating expenses	\$ 1,648		\$ 4,535	
Total stock-based compensation expense	\$ 1,662	\$	\$ 4,574	\$

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

	Three Months Ended		Nine Months Ended	
	September 30, 2006	September 30, 2005	September 30, 2006	September 30, 2005 ⁽¹⁾
Net income (loss), as reported for prior periods ⁽¹⁾	N/A	\$ 110	N/A	\$ (2,786)
Add stock compensation expense recorded under the intrinsic value method	N/A	297	N/A	606
Less stock-based compensation expense computed under the fair value method ⁽²⁾		(1,687)		(4,406)
Net income (loss), including the effect of stock-based compensation expense ⁽³⁾	\$ (1,529)	\$ (1,280)	\$ (1,747)	\$ (6,586)

Edgar Filing: MICROTUNE INC - Form 10-Q

Basic and diluted loss per common share, as reported in prior periods ⁽¹⁾	N/A	\$ 0.00	N/A	\$	(0.05)
Basic net income (loss) per common share, including the effect of stock-based compensation expense ⁽³⁾	\$ (0.03)	\$ (0.02)	\$ (0.03)	\$	(0.13)
Diluted net income (loss) per common share, including the effect of stock-based compensation expense ⁽³⁾	\$ (0.03)	\$ (0.02)	\$ (0.03)	\$	(0.13)

-
- (1) Net loss and net loss per share prior to 2006 did not include stock-based compensation expense under SFAS No. 123 because we did not adopt the recognition provisions of SFAS No. 123.
- (2) Stock-based compensation expense prior to 2006 is calculated based on the pro forma application of SFAS No. 123.
- (3) Net loss and net loss per share prior to 2006 represents pro forma information based on SFAS No. 123.

Table of Contents**MICROTUNE, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****September 30, 2006****(unaudited)**

The weighted-average estimated value of the stock options granted during the third quarter and first three quarters of 2006 was approximately \$3.12 per share and \$3.25 per share, respectively, using the Black-Scholes-Merton option-pricing formula with the following weighted-average assumptions:

	Three Months Ended	Nine Months Ended
	September 30,	September 30,
	2006	2006
Expected volatility	57.8%	60.3%
Risk-free interest rate	5.1%	4.8%
Expected dividends	0.0%	0.0%
Expected term (years)	5.0	5.0

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

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

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

The per share value of the restricted stock units granted during the second quarter of 2006 under the 2006 Executive Bonus Plan was \$6.40 using our closing stock-price on the grant date.

Our Employee Stock Purchase Plan has been deemed compensatory in accordance with SFAS No. 123(R). Stock-based compensation relating to this plan was estimated using a Black-Scholes-Merton option-pricing formula with assumptions previously disclosed under SFAS No. 123 as of the respective grant dates of the purchase rights provided to employees under the plan. The weighted-average estimated value of the purchase rights outstanding under this plan during the third quarter and first three quarters of 2006 was \$1.98 and \$2.01, respectively. During the third quarter and first three quarters of 2006, we recognized approximately \$0.1 million and \$0.4 million, respectively, of stock-based compensation expense as a result of this plan.

At September 30, 2006, the balance of unearned stock-based compensation to be expensed in future periods related to unvested share-based awards, as adjusted for expected forfeitures, is approximately \$9.9 million. The weighted-average period over which the unearned stock-based compensation is expected to be recognized is approximately 1.7 years. We anticipate that we will grant additional share-based awards to employees in the future, which will increase the stock-based compensation expense by the additional unearned compensation resulting from these grants. The fair value of these grants is not included in the amount above, as the impact of these grants cannot be predicted at this time because it will depend on the number of share-based payments granted. In addition, if factors change and we employ different assumptions in the application of SFAS No. 123(R) in future periods, the stock-based compensation expense that we record under SFAS No. 123(R) may differ significantly from what we have recorded in the current period.

Edgar Filing: MICROTUNE INC - Form 10-Q

See Note 2 for a discussion of the Audit Committee's independent investigation into our stock plan grant practices.

Table of Contents**MICROTUNE, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****September 30, 2006****(unaudited)****10. Geographic Information and Significant Customers**

Our corporate headquarters and principal design center are located in Plano, Texas. We have other sales offices and design centers in the United States and other worldwide locations. Net income (loss) from foreign operations totaled \$0.4 million and \$(0.2) million for the third quarter of 2006 and 2005, respectively. Net income (loss) from foreign operations totaled \$1.3 million and \$(0.8) million for the first three quarters of 2006 and 2005, respectively. Net revenue by geographical area is summarized below (in thousands):

	Three Months Ended		Nine Months Ended	
	September 30, 2006	September 30, 2005	September 30, 2006	September 30, 2005
North America	\$ 6,234	\$ 5,573	\$ 18,300	\$ 15,006
Europe	2,918	2,272	8,616	6,964
Asia Pacific	8,777	8,506	25,681	20,021
Other	36		63	28
Total	\$ 17,965	\$ 16,351	\$ 52,660	\$ 42,019

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

	Three Months Ended		Nine Months Ended	
	September 30, 2006	September 30, 2005	September 30, 2006	September 30, 2005
Scientific-Atlanta (a Cisco company) ⁽¹⁾	25%	22%	22%	22%
Asuspower/Asustek ⁽²⁾	17%	25%	16%	18%
Ten largest customers⁽³⁾	78%	82%	76%	75%

⁽¹⁾ Cisco Systems, Inc. (Cisco) completed its acquisition of Scientific-Atlanta on February 27, 2006. Revenue generated from Cisco, excluding Scientific-Atlanta, in the third quarter and first three quarters of 2006 was insignificant. Net revenue in the third quarter and first three quarters of 2005 excludes amounts attributed to Cisco.

⁽²⁾ Primarily for the benefit of ARRIS in the third quarter and first three quarters of 2006 and 2005.

⁽³⁾ Includes respective manufacturing subcontractors.

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

September 30, December 31,

Edgar Filing: MICROTUNE INC - Form 10-Q

	2006	2005
North America	\$ 2,849	\$ 3,139
Europe	1,005	893
Asia Pacific	354	366
Total	\$ 4,208	\$ 4,398

Table of Contents

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

Caution Regarding Forward-Looking Statements

All statements included or incorporated by reference in this quarterly report, other than statements of historical fact, are forward-looking statements. These forward-looking statements are based upon our current expectations, estimates and projections about our business and our industry, and reflect our beliefs and assumptions based upon information available to us at the date of this report and are therefore subject to change. In some cases, you can identify these statements by words such as if, may, might, will, should, could, would, expects, plans, believes, estimates, predicts, potential, continue, and other similar terms. These forward-looking statements include, but are not limited to, projections of our future financial performance and our anticipated growth, our accounting estimates, assumptions and judgments, the impact of new accounting pronouncements related to the expensing of stock options on our future results, the demand for our products, descriptions of our strategies, our product and market development plans, the trends we anticipate in our business and the markets in which we operate, the competitive nature and anticipated growth of those markets, our dependence on a few key customers for a substantial portion of our net revenue, our ability to continue to successfully partner with strategic demodulator partners, and our ability to successfully address new markets where competition is intense.

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

NOTE: For a more complete understanding of our financial condition and results of operations, and some of the risks that could affect our future results, see Risk Factors in Part II, Item 1A. below and in our other filings with the SEC which describes some of the important risk factors that may affect our business, results of operations and financial condition. You should carefully consider those risks, in addition to the other information in this report and in our other filings with the SEC, before deciding to make an investment in our stock. You should also read Quantitative and Qualitative Disclosures About Market Risk in Part I, Item 3.

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

RESTATEMENT OF CONSOLIDATED FINANCIAL STATEMENTS, AUDIT COMMITTEE AND COMPANY FINDINGS, REMEDIAL MEASURES AND RELATED PROCEEDINGS

Restatement of Consolidated Financial Statements

During May 2006, after extensive press coverage regarding the stock option dating practices of other companies, our Board of Directors inquired about our own practices. An initial review of high-level timing and pricing characteristics related to historical equity grants indicated no apparent issues. However, in connection with a proposed annual grant to all employees (originally scheduled to occur in early June 2006), and due to management's concern about the timing of the proposed grant relative to our normal trading black-out schedule, management further examined past stock option grant paperwork for the purpose of understanding past granting trends and discovered potentially problematic documentation. Management communicated its concerns to the Audit Committee in June 2006, and the Audit Committee self-initiated an investigation into our stock option grant practices covering the period from the date of our initial public offering, or IPO, on August 4, 2000 through June 2006. The Audit Committee retained independent legal counsel on or about July 3, 2006. Subsequently, the Audit Committee's independent legal counsel retained an independent accounting firm to provide independent accounting and electronic forensic assistance. Management utilized its regular tax advisors to perform certain tax analysis services. The investigation included the evaluation of all stock option grants from August 4, 2000 through June 30, 2006, which encompassed more than 2,000 individual stock option grants to purchase more than 15 million shares of our common stock.

Table of Contents

The Audit Committee's legal and accounting advisors reviewed thousands of pages of hard copy and electronic documents, captured and analyzed over two million e-mail messages and conducted over 20 formal interviews with current and former employees, officers and directors. Current members of our management team cooperated fully with the Audit Committee's investigation.

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

On December 29, 2006, we announced that the Audit Committee had completed its investigation and had made certain determinations. As a result of the Audit Committee's investigation, we have recorded additional stock-based compensation expense and related tax liabilities for certain stock option grants made during the review period. In January 2007, we determined to restate our selected consolidated financial data as of and for the years ended December 31, 2000 and 1999. We have restated our consolidated financial statements for the years ended December 31, 2005, 2004, and 2003, and the selected consolidated financial data as of and for the years ended December 31, 2005, 2004, 2003, 2002, 2001, 2000 and 1999, to correctly account for: (1) improper measurement dates for stock option grants, including those relating to stock option plan administration deficiencies, delays in completing granting actions and paperwork, and mischaracterizations of stock option recipients; (2) modifications to stock option grants; (3) employee stock purchase plan administration deficiencies; (4) stock option grants to non-employees; and (5) related tax liabilities, including those associated with the misclassification of certain stock option grants as incentive stock options, or ISOs, and consequently, the underreporting or underwithholding of payroll taxes on certain stock option exercises.

Table of Contents

The financial impact of the Audit Committee's findings on our consolidated financial statements for the years ended December 31, 1999 through 2006 is as follows (in thousands):

	Year Ended December 31,								
	2006	2005	2004	2003	2002	2001	2000	1999	Total
Category 1: Improper measurement date for stock option grants	\$ 61	\$ 508	\$ 525	\$ 1,169	\$ 3,513	\$ 823	\$ 21	\$	\$ 6,620
Category 2: Modifications to stock option grants			(7)	(80)	199	244	71	99	526
Category 3: Employee stock purchase plan		30	74	16	10	62			192
Category 4: Stock option grants to non-employees			5	68	44	153	785	133	1,188
Total stock-based compensation expense	61	538	597	1,173	3,766	1,282	877	232	8,526
Category 5: Related tax liabilities	304	109	141	11	2	7			574
Total	\$ 365	\$ 647	\$ 738	\$ 1,184	\$ 3,768	\$ 1,289	\$ 877	\$ 232	\$ 9,100

Although SFAS No. 123 allows us to continue to follow APB No. 25 guidelines, we are required to disclose pro forma net income (loss) and net income (loss) per share as if we had adopted SFAS No. 123 for our primary financial statements. The pro forma impact of applying SFAS No. 123 will not necessarily be representative of the expense we will incur in future periods under SFAS No. 123R, *Share-Based Payment*. Our pro forma information, as restated, is as follows (in thousands, except per share data):

	Year Ended December 31,				
	2005 Restated ⁽¹⁾	2004 Restated ⁽¹⁾	2003 Restated ⁽¹⁾	2002 Restated ⁽¹⁾	2001 Restated ⁽¹⁾
Net income (loss), as restated	\$ (2,438)	\$ 4,790	\$ (51,523)	\$ (186,631)	\$ (68,508)
Add stock compensation expense recorded under the intrinsic value method	706	1,497	5,246	17,118	5,204
Less pro forma stock compensation expense computed under the fair value method	(6,146)	(6,902)	(9,821)	(11,143)	(9,761)
Pro forma net loss, as restated	\$ (7,878)	\$ (615)	\$ (56,098)	\$ (180,656)	\$ (73,065)
Basic and diluted pro forma loss per common share	\$ (0.15)	\$ (0.01)	\$ (1.11)	\$ (3.45)	\$ (1.81)

(1) See Note 2, Restatement of Consolidated Financial Statements, to the Notes to Consolidated Financial Statements for a discussion of the cumulative affect of the above financial impact on beginning retained earnings.

Audit Committee and Company Findings

As disclosed above, our Audit Committee, which consists solely of independent directors, self-initiated an investigation into our stock option grant practices. As a result of this investigation, we have identified errors with an aggregate financial impact of approximately \$9.1 million. In the table above describing the financial impact of the Audit Committee's findings on our restated consolidated financial statements, we have summarized the aggregate financial impact of the errors into five categories as further described in the table. Certain amounts reflected in the table are the result of errors from earlier periods due to the accounting treatment for such errors that requires the amortization of the errors over multiple periods. For example, only approximately \$1.0 million of the \$9.1 million adjustment resulted from errors in periods after August 12, 2003, the date of the appointment of Mr. James A. Fontaine as CEO; however, approximately \$2.0 million of the adjustment actually impacts our financial results after August 12, 2003. As a result of the Audit Committee's investigation, we have determined the following:

Edgar Filing: MICROTUNE INC - Form 10-Q

Inappropriate Practices Prior to August 12, 2003. The Audit Committee has identified the following inappropriate practices, each of which occurred prior to the appointment of Mr. Fontaine on August 12, 2003:

We followed a regular practice of backdating stock option grants to each new employee to the date corresponding to the lowest closing stock price during approximately a one to two week period after such new employee's start date. Once a favorable price was selected, other (non-new employee) grants planned during the same timeframe were also generally dated with the date selected to take advantage of the low exercise price. Grants of this type consisted of approximately 1.0 million stock options and involved a large number of individual granting actions. The total financial impact of these errors account for less than \$0.4 million of the Category 1 adjustment. New measurement date determinations for this category were generally based on documentation in the corporate minute books indicating when listings of stock prices for a range of dates were printed and/or electronic date stamping showing when the granting action documentation was prepared. The Audit Committee concluded that granting actions were signed on the same date the stock price range page was printed, leading us to conclude that this was the most likely measurement date.

On several occasions, in order to select favorable exercise prices for certain newly-hired executives or other senior personnel, we created employment records to establish start dates (and grant dates) that preceded the date they actually began working for us. We do not currently employ any person who benefited from this practice. The total financial impact of these errors, included in the Category 1 adjustment, was approximately \$1.2 million and consists of three instances involving four individuals who received an aggregate of 580,000 stock options. For two of these instances, which involved three individuals, the actual start dates were determined to be later than the stated start and grant dates through an examination of the employees' personnel or payroll files and through a review of email messages dated weeks after the stated start and grant dates, describing the intent of prior senior management to create fictitious start dates for these employees such that favorable exercise prices could be selected. Both of these grants were approved by unanimous written consent, or UWC, with effective dates that preceded the date that they were actually signed. Based on an analysis of electronic date stamping information and an examination of the original documentation, we have concluded that the UWC was actually signed on the date of the Compensation Committee meeting and have determined that such date is the most likely measurement date for these grants. The total financial impact of errors for these instances was approximately \$1.0 million. For the other instance, which involved one individual, the approval of the grant did not occur until several weeks after the stated grant date. This grant was also approved by a UWC with an effective date that preceded the date the UWC was actually signed. We determined the measurement date for this grant to be the date that final approval was received from the Compensation Committee as evidenced by the receipt of an electronic signature page and supporting electronic date stamping evidence. The total financial impact of this error for this grant was approximately \$0.2 million.

We backdated certain other stock option grants by selecting a grant date and corresponding exercise price that preceded the date that we actually determined to make such grants. In some cases, these stock option grants were backdated by several months. The total financial impact of these errors was approximately \$4.2 million and is included in the Category 1 adjustment. For example, on one occasion, for a grant to eleven members of management totaling 439,000 stock options, the approval of the grant did not occur until several weeks after the stated grant date. This grant was approved by a UWC of our Compensation Committee with an effective date that preceded the date the UWC was actually signed. We determined the measurement date for this grant to be the date that final approval was received from the Compensation Committee as evidenced by receipt of an electronic signature page and supporting electronic date stamping evidence. The total financial impact for this single error was approximately \$2.2 million. On another occasion, for a grant to five members of management totaling 490,000 stock options, the approval of the grant did not occur until several weeks after the stated grant date. This grant was approved by a UWC with an effective date that preceded the date the UWC was actually signed. Based on an analysis of electronic date stamping and an examination of original documentation, we have concluded that the UWC was actually signed on the date of the Compensation Committee meeting and that such date is the most likely measurement date for this grant. The total financial impact of this error was approximately \$0.7 million and is included in the Category 1 adjustment.

In two instances involving a large number of employees, stock options were granted and subsequently regranted using a lower exercise price. The re-grant was not properly accounted for using variable accounting. The total financial impact for these errors was \$0.1 million and is included in the Category 1 adjustment.

Until August 2004, conditions were in place to allow option holders to select an exercise date (and associated price for calculating any tax impact) up to three days earlier than the date we actually received the employees' notices of exercise and payment of the exercise price but only for transactions where the employee desired to exercise and hold the shares. For cashless exercises, this alternative was not available. In August 2004, the settlement of our stock option exercises was transitioned to a third-party provider,

Edgar Filing: MICROTUNE INC - Form 10-Q

which precluded the possibility of any further occurrences of exercise date manipulation. Due to inconclusive evidence, the Audit Committee could not determine whether this was a widespread practice; however, it did confirm that exercise date manipulation occurred in seven instances. We recorded a nominal amount of compensation expense for these seven instances based on the specific evidence supporting a finding of manipulation. For other stock option exercises, we have determined that slightly more than 50 percent were not dated such that the most favorable exercise price, during the three day period, was obtained. We have therefore determined that the likelihood is remote that these transactions were manipulated. In other cases, a number of transactions exist for which the evidence is inconclusive such that we could not eliminate the possibility that these exercise dates were manipulated; however, we have determined that no additional compensation expense would need to be recorded. If certain of these transactions are later challenged and determined to have been manipulated, we can reduce or eliminate the financial impact to us by amending the previously filed W-2 forms for the affected employees and our related net operating loss carryforward. Under one possible scenario, we have estimated the potential additional compensation charge, net of tax, to be between approximately \$0.2 million and \$0.3 million if amended W-2 forms are not filed.

Stock Option Plan Administration Deficiencies. The Audit Committee also found that during the period from our IPO until June 2004, when granting employee stock options, we incorrectly used the closing stock price from the day prior to the actual date of grant to determine the fair market value of our common stock and the exercise price of the stock option, rather than the closing stock price on the grant date as contemplated by our 2000 Stock Plan. The Audit Committee and management have determined that we must record a compensation charge as a result of this error. The Audit Committee believes, however, that this practice was not used to select favorable exercise prices. For grants for which there were no other errors, the financial impact of this error was approximately \$0.3 million. Amounts related to these errors are included in the Category 1 adjustment. For grants that were misdated and described in other sections of this summary, the error relating to the use of prior day pricing was not separately quantified.

Delays in Completing Granting Actions and Paperwork after August 12, 2003. The Audit Committee also found that, as part of the 2004 and 2005 annual stock option grant process, an aggregate number of grants to all employees were presented to the Board of Directors or Compensation Committee and approved as to total number and exercise price, but the actual number of option shares (or other material stock option terms) to be granted to each individual employee was not finalized for every employee until several days or weeks after the recorded grant date. The Audit Committee and management have determined that compensation expense relating to these annual grants must be recorded. The total financial impact of these errors was approximately \$0.4 million and is included in the Category 1 adjustment. For example, in one instance, four block stock option grants, representing different employee groupings, were approved by the Board of Directors with individual stock option grants to be determined by the Chief Executive Officer, pursuant to his delegated authority and in accordance with the terms of the block grants approved by the Board of Directors. Grant allocations to individual recipients for one of the pre-approved block grants were not finalized for six days. For accounting purposes, we determined that the measurement date for all stock option grants in the four block grants must coincide with the date that the stock option grant allocations were determined with finality for all recipients, as evidenced by the date of email messages and the electronic date stamping of relevant spreadsheet files. In this instance, the financial impact of the error resulted in compensation expense of less than \$0.1 million and is included in the Category 1 adjustment. In another instance, block stock option grants were approved by the Compensation Committee in a meeting with individual stock option grants to be made by the Chief Executive Officer, pursuant to his delegated authority and in accordance with the terms of the block grants approved by the Compensation Committee. As we could not reasonably determine when the stock option grant allocations were finalized for all recipients, we determined the measurement date based upon the electronic date stamping associated with the granting actions that were recorded in our corporate minute books. In this instance, the financial impact of the error resulted in compensation expense of approximately \$0.3 million and is included in the Category 1 adjustment. Separately, the Audit Committee noted that, on occasion, there were administrative delays in executing the paperwork to effectuate certain grants to new employees, though these delays do not create a need to record additional compensation expense. The Audit Committee believes that none of these delays were attempts to select more favorable exercise prices.

Accounting Errors Associated with Stock Option Modifications or Mischaracterizations of Stock Option Recipients. Until approximately December 2003, in connection with the severance arrangements provided to certain terminated employees, we extended the vesting period, the exercise period or both, or provided a nominal salary in order to allow the terminated employee's stock option awards to continue to vest as part of his or her severance arrangement. We also modified the performance vesting goals of certain stock option grants on several occasions after receiving Board or Compensation Committee approval. Because these practices had the effect of modifying the original terms of the stock option grants, the Audit Committee and management have determined that we should have recorded compensation expense for certain of these stock option grant modifications. These errors resulted in an aggregate compensation expense of approximately \$0.5 million, and are included in the Category 2 adjustment. For purposes of accounting for stock option modifications involving the extension of the vesting period, the exercise period or both for a given stock option award, we determined the applicable termination date and modification date of each affected employee from either the applicable severance agreement or other documentation in the employee's personnel file, including the actual dates reflected in our stock option database.

We also failed to correctly account for certain stock option grants to non-employees (e.g., advisors or independent contractors), with the result that compensation expense was not appropriately recorded. The financial impact of the errors related to the accounting for non-employee stock option grants was approximately \$1.2 million and is reflected in the Category 4 adjustment. These grants were accounted for under the fair value provisions of SFAS No. 123.

Edgar Filing: MICROTUNE INC - Form 10-Q

Taxes. As described above, certain grants of stock options made during the period under investigation were priced below fair market value, rather than at fair market value. Consequently, certain grants intended to be classified as ISOs, requiring pricing at no less than fair market value on the date of grant, should have been classified as nonqualified stock options, or NQs. Given the significant differences in the tax treatment between ISOs and NQs, we underreported or underwithheld certain payroll taxes for those options which were exercised during the period through June 30, 2006. We have recorded certain tax liabilities related to these issues in the period of exercise with related penalties and interest charged in subsequent periods, except for periods closed by the statute of limitations where no liability is recorded. We intend to pursue a negotiated settlement with the IRS as soon as practicable, however, there can be no assurance that we will settle these issues for amounts consistent with the estimated liabilities we have recorded. In the aggregate, the financial impact of these tax errors was approximately \$0.6 million and are included in the Category 5 adjustment.

Administrative Errors Associated with the ESPP. During the investigation, the Audit Committee discovered certain administrative pricing errors with some purchases by certain employees in previous purchase periods under our employee stock purchase plan. These errors resulted in the assignment of purchase prices for some employees that were slightly lower than the purchase prices actually required by the plan. We have agreed in principle to a settlement with the IRS related to these issues for an amount that approximates the liability we have recorded. We have recorded the estimated liabilities in the appropriate past periods. These errors also caused certain purchases to be compensatory; accordingly, we have recorded compensation expense for these instances. The financial impact of these errors was approximately \$0.2 million and is included in the Category 3 adjustment.

Involvement of Current Management. As a result of its investigation, our Audit Committee has concluded that there was no intentional wrongdoing by our current Chief Executive Officer, Chief Financial Officer or General Counsel, or by our Board of Directors. The Audit Committee and the Board have further concluded that both our current Chief Executive Officer, Mr. James A. Fontaine, and current Chief Financial Officer, Mr. Jeffrey A. Kupp, have appropriately served and can continue to serve as certifying officers with respect to our financial statements and the Audit Committee and Board have expressed their full confidence in the integrity of Mr. Fontaine and Mr. Kupp.

Table of Contents

Remedial Measures

We are committed to remediating the problems associated with our past stock option granting practices. In June 2006, our management identified potentially problematic documentation related to certain past equity compensation awards and reported these findings to the Audit Committee, which contributed to the Audit Committee's decision to initiate an investigation into our stock option grant practices. In addition, after identifying these deficiencies, in June 2006, management implemented certain improvements to our control environment as well as to controls over the administration of and accounting for our equity compensation awards. These control improvements, described below, were applied to all equity compensation awards between mid-June 2006 and the end of October 2006 (at which time all activity under our equity compensation plans was suspended due to the pending restatement) and had the effect of remediating the material weaknesses related to our stock option granting procedures:

we added certain procedures to ensure the accuracy and completeness of stock option granting paperwork, including a review by our General Counsel prior to the taking of any granting action;

our Chief Financial Officer provided the correct fair market value price on the date of grant to be used to establish the exercise price of the particular equity compensation award, by verifying the correct closing sales price for the grant date;

we added certain procedures to ensure that the appropriate authorization of each equity compensation award was actually documented and received by us on the date of grant; and

we adjusted the process so that our Chief Financial Officer and General Counsel were aware in advance of planned equity compensation awards to ensure that potential legal and accounting issues were thoroughly investigated and resolved prior to the taking of any granting action.

Table of Contents

Furthermore, the Audit Committee issued a report to our Board of Directors in December 2006 recommending certain additional improvements to our stock option granting procedures. We adopted their recommendations, which had the effect of further strengthening our controls related to our stock option granting procedures. The additional control procedures recommended by the Audit Committee and approved by our Board include the following:

We have designated an employee highly trained in the legal and accounting implications of stock option grants to be responsible for administering and monitoring stock option grants. This employee reports to, and his work is reviewed by, our Chief Financial Officer and General Counsel. His responsibilities include, among other things, (1) reviewing all proposed grants before such grants are submitted to the Board or Compensation Committee to ensure that such grants are being made in accordance with applicable law and corporate authority and to ensure that such grants are complete and accurate in all respects; and (2) ensuring that the exercise price established for the stock option grants is equal to or higher than the fair market value of the underlying common stock on the grant date by comparing such exercise price to the closing price of our common stock on the same date that the grant has occurred.

Except in unusual circumstances, we will ensure that all stock option grants will be reflected in resolutions set forth in the minutes of a meeting of the Board or Compensation Committee. Such minutes will be prepared promptly following the action taken at the meeting, and unnecessary ratifications or subsequent approvals will not be requested. If stock option grants are awarded pursuant to a unanimous written consent, we will take care to document the circumstances requiring the use of a unanimous written consent. Additionally, the unanimous written consent will be signed by the appropriate persons and returned to us for inclusion in our records by the date specified as the grant date.

Except under unusual circumstances, all stock option grants to new hires in connection with their offers of employment will be granted on a predetermined day of the month. Our Equity Compensation Award Policy (described below) specifies the procedures if the predetermined date is a holiday or another date that we are not generally open for business. Further, the policy includes a mechanism for selecting an alternative day, if for any reason, the Board or Compensation Committee is unable to meet and take action as planned.

Annual grants to employees for performance or retention will be made during the same time periods each year.

No annual stock option grants will be made during any period designated as a quarterly blackout period under our insider trading policy.

Our stock option granting procedures will be in writing and will be reviewed by our Chief Financial Officer, General Counsel and outside counsel annually to ensure compliance with all applicable laws and regulations.

In no case will awards be made to employees prior to the applicable date of hire.

We are committed to observing all of the above remedial measures and we have adopted an Equity Compensation Award Policy to enact these measures. Among other things, the policy provides that any deviation from the policy must receive prior approval from our Board. Such Board approval may only be given after full consideration of the market timing issues and legal risks associated with any such deviation. The policy generally provides that concerns regarding the timing of any grant should be communicated to our General Counsel and Chief Financial Officer by the Chairperson of the Compensation Committee. Finally, the policy provides for documentation of any such deviation.

Regulatory Matters

We have informed the SEC of the Audit Committee's investigation of our stock option grant practices and we intend to cooperate with the SEC in any investigation into this matter.

Edgar Filing: MICROTUNE INC - Form 10-Q

On August 9, 2006, we notified The NASDAQ Stock Market that we had not timely filed our Quarterly Report on Form 10-Q for the quarter ended June 30, 2006 with the SEC. Therefore, we were not in compliance with NASDAQ's filing requirement as set forth in NASDAQ Marketplace Rule 4310(c)(14), which requires, among other things, that we timely file

Table of Contents

all required reports with the SEC. Consequently, on August 14, 2006, we received a staff determination letter from the staff of NASDAQ indicating that our failure to timely file our Quarterly Report on Form 10-Q for the quarter ended June 30, 2006 served as a basis for delisting our common stock from The NASDAQ Global Market at the opening of business on August 23, 2006 unless we requested a hearing in accordance with NASDAQ Marketplace Rules 4800 through 4811. We requested a hearing, which was held on September 21, 2006, at which we requested the continued listing of our common stock. On November 13, 2006, we notified The NASDAQ Stock Market that we had not timely filed our Quarterly Report on Form 10-Q for the quarter ended September 30, 2006 with the SEC. Therefore, we were not in compliance with NASDAQ's filing requirement as set forth in NASDAQ Marketplace Rule 4310(c)(14) and described above. Consequently, on November 14, 2006, we received an additional staff determination letter from the staff of NASDAQ indicating that our failure to timely file our Quarterly Report on Form 10-Q for the quarter ended September 30, 2006 as required served as an additional basis for delisting our common stock from The NASDAQ Global Market.

On November 16, 2006, we received notice that the Listing Qualifications Panel of The NASDAQ Stock Market had granted our request for the continued listing of our common stock on The NASDAQ Global Market. The continued listing of our common stock was subject to two conditions. First, on or about December 4, 2006, we were required to provide additional information to NASDAQ regarding our Audit Committee's internal investigation of our stock option grant practices. On December 4, 2006, we provided the NASDAQ Listing Qualifications Panel with the preliminary findings of the Audit Committee's investigation into our stock option granting practices. Second, on or before January 22, 2007, we were required to file our Quarterly Reports on Form 10-Q for the quarters ended June 30, 2006 and September 30, 2006, respectively, and any necessary restatements of our prior financial statements with the SEC. We are filing such Quarterly Reports contemporaneously with this amended Annual Report on Form 10-K/A and an amended Quarterly Report on Form 10-Q/A for the quarter ended March 31, 2006. As of the date of this filing, we believe we have satisfied the foregoing conditions for the continued listing of our common stock on The NASDAQ Global Market.

Costs of Restatement and Legal Activities

We have incurred substantial expenses for legal, accounting, tax and other professional services in connection with the Audit Committee's investigation, the preparation of our restated financial statements and related regulatory matters. We have incurred expenses of approximately \$2.9 million through December 31, 2006 related to these matters. We incurred approximately \$1.4 million in the quarter ended September 30, 2006. We expect to continue to incur substantial expenses in connection with these matters. For example, we may also incur expenses of up to approximately \$1.0 million in order to resolve certain Section 409A tax issues resulting from misdated stock options to certain of our employees. In addition, we may be obligated to indemnify and advance legal expenses to certain current and former officers pursuant to the requirements of Delaware law and our indemnification agreements with such current and former officers for legal proceedings related to these matters.

OVERVIEW

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

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

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

Table of Contents

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

Cable

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

Digital TV

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

Automotive Electronics

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

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

Net Revenue: Our net revenue is generated principally by sales of our integrated circuits and subsystem module products directly to OEMs and ODMs who sell devices or applications to consumers or service providers (cable) within the cable, digital TV and automotive markets. The devices or applications that our customers produce include cable TV set-top boxes; cable high-speed data modems; cable high-speed voice modems enabling cable-based digital phone services; car audio, video and antenna amplifier systems; digital/analog TVs, including HDTVs; PC/TV multimedia products; and mobile TVs. We also market and sell to third-party manufacturers and to distributors who sell directly to the OEMs and ODMs. The majority of our net revenues are generated through the efforts of our sales organization. However, we generated approximately 18% and 10% of our net revenue from sales made through distributors in the third quarter of 2006 and 2005, respectively. We generated approximately 20% and 11% of our net revenue from sales made through distributors in the first three quarters of 2006 and 2005, respectively. Our net revenue varies based upon economic and market conditions in the semiconductor industry and our target markets; the timing, rescheduling or cancellation of significant customer orders; our ability, as well as the ability of our customers, to manage inventory; and large orders placed by our key customers. These factors may cause our quarterly and yearly net revenue to fluctuate significantly, which makes it difficult for us to discuss revenue trends or to predict future results. We expect these fluctuations will continue in the future. We analyze trends in total net revenue and we attempt to analyze total net revenue trends by market, which is limited due to our lack of visibility into customers and/or applications, as described above. We also analyze revenue from key customers, focusing on our ten-percent customers, and aggregate net revenue from our top ten customers.

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

products enabling us to employ a limited number of production

Table of Contents

employees. Our cost of revenue may increase due to price fluctuations and cyclical demand and we may not be able to pass this increase on to our customers, which makes it difficult for us to determine if cost of revenue and gross margin trends will continue or to predict future results. We analyze absolute gross margin dollars and gross margin percentage. We also analyze the key drivers of gross margin, namely typical selling price trends and the components of cost of revenue. The typical selling price of our tuner ICs ranges generally from \$2 to \$3. The typical selling price of our subsystem module products ranges generally from \$6 to \$25. Throughout the remainder of 2006, we expect the average selling price of our products to remain flat or slightly decrease; however, more significant decreases could have a material adverse impact on our gross margins, financial condition and results of operations.

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

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

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

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

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

	Three Months Ended		Nine Months Ended	
	September 30, 2006	September 30, 2005	September 30, 2006	September 30, 2005
Net income (loss), as reported for prior periods ⁽¹⁾	N/A	\$ 110	N/A	\$ (2,786)
Add stock compensation expense recorded under the intrinsic value method	N/A	297	N/A	606
Less stock-based compensation expense computed under the fair value method ⁽²⁾		(1,687)		(4,406)
Net income (loss), including the effect of stock-based compensation expense ⁽³⁾	\$ (1,529)	\$ (1,280)	\$ (1,747)	\$ (6,586)
Basic and diluted loss per common share, as reported in prior periods ⁽³⁾	N/A	\$ 0.00	N/A	\$ (0.05)
Basic income (loss) per common share, including the effect of stock-based compensation expense ⁽³⁾	\$ (0.03)	\$ (0.02)	\$ (0.03)	\$ (0.13)
Diluted income (loss) per common share, including the effect of stock-based compensation expense ⁽³⁾	\$ (0.03)	\$ (0.02)	\$ (0.03)	\$ (0.13)

-
- (1) Net loss and net loss per share prior to 2006 did not include stock-based compensation expense under SFAS No. 123 because we did not adopt the recognition provisions of SFAS No. 123.
 - (2) Stock-based compensation expense prior to 2006 is calculated based on the pro forma application of SFAS No. 123.
 - (3) Net loss and net loss per share prior to 2006 represents pro forma information based on SFAS No. 123.

Table of Contents**RESULTS OF OPERATIONS**

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

	Three Months Ended		Nine Months Ended	
	September 30, 2006	September 30, 2005	September 30, 2006	September 30, 2005
Net revenue	100%	100%	100%	100%
Cost of revenue	50	50	50	47
Gross margin	50	50	50	53
Operating expenses:				
Research and development	29	25	29	29
Selling, general and administrative	35	24	30	29
Amortization of intangible assets		4		5
Total operating expenses	64	53	59	63
Loss from operations	(14)	(3)	(9)	(10)
Other income (expense)	6	4	6	4
Income (loss) before provision for income taxes	(8)	1	(3)	(6)
Income tax expense				
Net income (loss)	(8)%	1%	(3)%	(6)%

COMPARISON OF THE THREE MONTHS AND NINE MONTHS ENDED SEPTEMBER 30, 2006 AND 2005**Net Revenue**

The following table presents net revenue from each of our product types in the third quarter and first three quarters of 2006 as compared to the third quarter and first three quarters of 2005 (in thousands):

	Three Months Ended				Nine Months Ended			
	2006	September 30, 2005	Change	% Change	2006	September 30, 2005	Change	% Change
Silicon	\$ 13,763	\$ 12,787	\$ 976	7.6%	\$ 40,595	\$ 31,013	\$ 9,582	30.9%
Modules	4,173	3,535	638	18.0	11,708	10,853	855	7.9
Other	29	29			357	153	204	133.3
Total	\$ 17,965	\$ 16,351	\$ 1,614	9.9%	\$ 52,660	\$ 42,019	\$ 10,641	25.3%

The increase in net revenue in the third quarter of 2006 as compared to the third quarter of 2005 is primarily the result of increased shipments of silicon tuner products for cable and digital TV markets, partially offset by decreased shipments of amplifier products for cable markets. In addition, the increase in net revenue in the third quarter of 2006 is the result of increased shipments for automotive markets. Silicon tuner unit shipments increased approximately 34% from the third quarter of 2005 to the third quarter of 2006, primarily in cable and digital TV markets and the change in module unit shipments was insignificant. Silicon amplifier unit shipments decreased approximately 65% from the third quarter of 2005 to the third quarter of 2006, primarily in cable and other markets. We expect net revenues to grow approximately 20 to 22% for the year 2006, primarily due to design wins in the cable and digital TV markets and growth from existing designs.

Edgar Filing: MICROTUNE INC - Form 10-Q

The increase in net revenue in the first three quarters of 2006 as compared to the first three quarters of 2005 is primarily the result of increased shipments of silicon tuner and amplifier products for cable and digital TV markets, partially offset by decreased shipments of module products for cable and digital TV markets and decreased shipments of silicon upconverter products for cable markets. The increase in shipments for automotive markets also contributed to the increase in net revenue in the first three quarters of 2006. Silicon tuner unit shipments increased approximately 54% from the first three quarters of 2005 to the first three quarters of 2006, primarily in cable and digital TV markets and the change in module unit shipments was insignificant. Silicon amplifier unit shipments decreased approximately 15% from the first three quarters of 2005 to the first three quarters of 2006, primarily in other markets.

Table of Contents

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

	Three Months Ended		Nine Months Ended	
	September 30, 2006	September 30, 2005	September 30, 2006	September 30, 2005
Scientific-Atlanta (a Cisco company) ⁽¹⁾	25%	22%	22%	22%
Asuspower/Asustek ⁽²⁾	17%	25%	16%	18%
Ten largest customers ⁽³⁾	78%	82%	76%	75%

⁽¹⁾ Cisco Systems, Inc. (Cisco) completed its acquisition of Scientific-Atlanta on February 27, 2006. Revenue generated from Cisco, excluding Scientific-Atlanta, in the third quarter and first three quarters of 2006 was insignificant. Net revenue in the third quarter and first three quarters of 2005 excludes amounts attributed to Cisco.

⁽²⁾ Primarily for the benefit of ARRIS in the third quarter and first three quarters of 2006 and 2005.

⁽³⁾ Includes respective manufacturing subcontractors.

In the third quarter of 2006 and 2005, we recognized 1% and 2%, respectively, of our net revenue upon receipt of payment. In the first three quarters of 2006 and 2005, we recognized 5% of our net revenue upon receipt of payment.

Cost of Revenue and Gross Margin

The following table presents cost of revenue and gross margin in the third quarter and first three quarters of 2006 as compared to the third quarter and first three quarters of 2005 (in thousands):

	Three Months Ended				Nine Months Ended			
	2006	2005	September 30, Change	% Change	2006	2005	September 30, Change	% Change
Cost of Revenue	\$ 9,071	\$ 8,201	\$ 870	10.6%	\$ 26,100	\$ 19,801	\$ 6,299	31.8%
Gross Margin	8,894	8,150	744	9.1	26,560	22,218	4,342	19.5
Gross Margin %	49.5%	49.8%	(0.3) pts.		50.4%	52.9%	(2.5) pts.	

Gross margin increased in the third quarter of 2006 as compared to the third quarter of 2005 primarily due to an approximate \$1.6 million increase in net revenue. Gross margin percentage in the third quarter of 2006 as compared to the third quarter of 2005 decreased due to changes in the product and customer mix of our silicon tuner products for cable and digital TV markets and a decreased benefit from changes in inventory valuation allowances. We expect our gross margin percentage to remain fairly flat throughout 2006.

Gross margin increased in the first three quarters of 2006 as compared to the first three quarters of 2005 primarily due to an approximate \$10.6 million increase in net revenue. Gross margin percentage in the first three quarters of 2006 as compared to the first three quarters of 2005 decreased primarily due to a one-time cost of revenue credit of approximately \$0.7 million realized in conjunction with the transition of our third-party contract manufacturer for our module products during the second quarter of 2005. In addition, gross margin percentage in the first three quarters of 2006 as compared to the first three quarters of 2005 was negatively impacted by a change in the product mix of our silicon tuner products for cable and digital TV markets and decreased revenue from our silicon upconverter products for cable markets, which generally have a higher gross margin percentage as compared to other products. Gross margin percentage in the first three quarters of 2006 as compared to the first three quarters of 2005 was positively impacted by increased revenue from our silicon products as a percentage of net revenue, which generally have a higher gross margin percentage compared to the mix of products sold in the first three quarters of 2005.

Table of Contents

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

Our cost of revenue for the first three quarters of 2006 and 2005 did not include approximately \$0.9 million and \$0.8 million, respectively, of costs relating to the sale of inventory which had previously been written-off as excess. The net impact of changes in the inventory valuation allowances for the first three quarters of 2006 was insignificant. The net impact of changes in the inventory valuation allowances for the first three quarters of 2005 was a benefit to cost of revenue of approximately \$0.2 million.

Stock-Based Compensation

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

	Three Months Ended		Nine Months Ended	
	September 30, 2006	September 30, 2005	September 30, 2006	September 30, 2005
Cost of revenue	\$ 14	\$	\$ 39	\$
Research and development	672		1,903	
Selling, general and administrative	976		2,632	
Total stock-based compensation expense included in operating expenses	\$ 1,648		\$ 4,535	
Total stock-based compensation expense	\$ 1,662	\$	\$ 4,574	\$

Operating Expenses

The following table presents operating expenses for the third quarter and first three quarters of 2006 as compared to the third quarter and first three quarters of 2005 (in thousands):

	Three Months Ended				Nine Months Ended			
	2006	September 30, 2005	Change	% Change	2006	September 30, 2005	Change	% Change
Research and development	\$ 5,172	\$ 4,083	\$ 1,089	26.7%	\$ 15,316	\$ 12,173	\$ 3,143	25.8%
Selling, general and administrative	6,331	3,897	2,434	62.5%	15,997	12,361	3,636	29.4%
Amortization of intangibles		660	(660)	(100.0)		2,008	(2,008)	(100.0)
Total	\$ 11,503	\$ 8,640	\$ 2,863	33.1%	\$ 31,313	\$ 26,542	\$ 4,771	18.0%

Research and Development

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

Table of Contents

The increase in research and development expenses in the third quarter of 2006 as compared to the third quarter of 2005 is primarily the result of an increase in personnel-related expenses resulting from increased average headcount and stock-based compensation expense, an increase in prototyping expenses for new silicon projects due to the timing of these expenditures and an increase in facilities and equipment expenses, partially offset by a decrease in depreciation expense. Stock-based compensation expense related to research and development was approximately \$0.7 million and \$0.2 million in the third quarter of 2006 and 2005, respectively. We expect research and development expenses to increase in 2006 as we intend to increase the number of RF IC and systems technical personnel.

The increase in research and development expenses in the first three quarters of 2006 as compared to the first three quarters of 2005 is primarily the result of an increase in personnel-related expenses resulting from increased average headcount and stock-based compensation expense, an increase in prototyping expenses for new silicon projects due to the timing of these expenditures and an increase in facilities and equipment expenses, partially offset by a decrease in depreciation expense. Stock-based compensation expense related to research and development was approximately \$1.9 million and \$0.4 million in the first three quarters of 2006 and 2005, respectively.

We remain committed to significant research and development efforts to extend our technology leadership in the markets in which we operate. Currently, we hold 67 issued United States utility patents and have more than 40 additional United States patent applications pending. Our issued United States patents begin to expire in 2015. Our patents cover various aspects of our RF and analog technologies at the broad architectural, circuit and building-block levels.

Selling, General and Administrative

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

The increase in selling, general and administrative expenses in the third quarter of 2006 as compared to the third quarter of 2005 is primarily due to an increase in stock-based compensation expense, personnel-related expenses and accounting and legal fees, partially offset by a decrease in directors and officers insurance expense and depreciation expense. Stock-based compensation expense related to selling, general and administrative was \$1.0 million and \$0.1 million in the third quarter of 2006 and 2005, respectively. Directors and officers insurance expense decreased as a result of a reduced annual premium effective September 2005. We expect selling, general and administrative expenses to increase significantly in 2006 primarily due to increased accounting and legal fees associated with our investigation into stock option granting practices and the related restatement of certain historical financial statements (See Note 2, Restatement of Consolidated Financial Statements to the Notes to Unaudited Consolidated Financial Statements), but to a lesser extent due to various expense categories driven by higher anticipated net revenue.

The increase in selling, general and administrative expenses in the first three quarters of 2006 as compared to the first three quarters of 2005 is primarily due to an increase in stock-based compensation expense and accounting and legal fees, partially offset by a decrease in directors and officers insurance expense and other insurance expenses. Stock-based compensation expense related to selling, general and administrative expense was \$2.6 million and \$0.2 million in the first three quarters of 2006 and 2005, respectively. Directors and officers insurance expense decreased as a result of a reduced annual premium effective September 2005. The results in the first three quarters of 2005 include an approximate \$0.5 million reimbursement of legal expenses from our insurance carriers related to our securities and derivative litigation. See our amended 2005 Annual Report on Form 10-K/A filed contemporaneously herewith for a description of these proceedings.

Amortization of Intangible Assets

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

Other Income and Expense

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

Table of Contents

The following table presents other income and expense for the third quarter and first three quarters of 2006 and 2005 (in thousands):

	Three Months Ended				Nine Months Ended			
	2006	September 30,		% Change	2006	September 30,		% Change
		2005	Change			2005	Change	
Interest income	\$ 1,117	\$ 662	\$ 455	68.7%	\$ 3,024	\$ 1,750	\$ 1,274	72.8%
Foreign currency gains (losses), net	(38)	6	(44)	(733.3)	113	(211)	324	153.6
Other	4	4			31	93	(62)	(66.7)
Total	\$ 1,083	\$ 672	\$ 411	61.2%	\$ 3,168	\$ 1,632	\$ 1,536	94.1%

The increase in interest income in the third quarter and first three quarters of 2006 as compared to the third quarter and first three quarters of 2005 is primarily the result of higher average cash and investment balances and higher average interest rates earned on our investments.

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

Income Taxes

The following table presents our provision for income taxes for the third quarter and first three quarters of 2006 and 2005 (in thousands):

	Three Months Ended				Nine Months Ended			
	2006	September 30,		% Change	2006	September 30,		% Change
		2005	Change			2005	Change	
Income tax expense	\$ 3	\$ 72	\$ (69)	(95.8)%	\$ 162	\$ 94	\$ 68	72.3%
Effective tax rate	(0.2)%	39.6%	(39.8) pts.		(10.2)%	(3.5)%	(6.7) pts.	

In the third quarter and first three quarters of 2006 and 2005, the effective tax rate differed from the 34% statutory corporate tax rate primarily due to permanent differences, mostly foreign currency remeasurement and stock-based compensation expense, changes in valuation allowances and lower foreign tax rates. The provision for taxes during third quarter of 2006 and 2005 consists of foreign income taxes.

Our income taxes are computed using the asset and liability method of accounting. Under the asset and liability method, a deferred tax asset or liability is recognized for estimated future tax effects attributable to temporary differences and carryforwards. The measurement of deferred income tax assets is adjusted by a valuation allowance, if necessary, to recognize future tax benefits only to the extent, based on available evidence, it is more likely than not such benefits will be realized. Our deferred tax assets were fully reserved at September 30, 2006 and December 31, 2005.

For United States federal income tax purposes, at December 31, 2005, we had a net operating loss carryforward of approximately \$169.0 million and an unused research and development credit carryforward of approximately \$4.4 million, that will begin to expire in 2011. A change in ownership, as defined in Section 382 of the Internal Revenue Code, may limit utilization of the United States federal net operating loss and research and development credit carryforwards.

Our income tax returns and those of our subsidiaries are subject to review and examination in the various jurisdictions in which we operate. During the third quarter of 2005, we recorded a provision for income taxes of approximately \$0.1 million relating to certain ongoing foreign reviews and examinations. These foreign reviews and examinations were fully resolved and all tax liabilities were paid during the fourth quarter of 2005 and first quarter of 2006. The tax liabilities paid differed from the previously recorded provision by an insignificant amount.

Table of Contents

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

Net Income (Loss)

The following table presents our net income (loss) for the third quarter and first three quarters of 2006 and 2005 (in thousands):

	Three Months Ended				Nine Months Ended			
	2006	2005	September 30, Change	% Change	2006	2005	September 30, Change	% Change
Net income (loss)	\$ (1,529)	\$ 110	\$ (1,639)	(1,490.0)%	\$ (1,747)	\$ (2,786)	\$ 1,039	37.3%
Percent of net revenue	(8.5)%	1.0%	(9.5) pts.		(3.3)%	(6.6)%	3.3 pts.	

The increase in net loss in the third quarter of 2006 as compared to the third quarter of 2005 was primarily the result of an increase in operating expenses due to stock-based compensation expense as described above, partially offset by an increase in net revenue, which resulted in an increase of \$0.7 million in gross margin, and an increase in interest income.

The decrease in net loss in the first three quarters of 2006 as compared to the first three quarters of 2005 was primarily the result of an increase in net revenue, which resulted in an increase of \$4.3 million in gross margin, and an increase in interest income, partially offset by an increase in operating expenses due to stock-based compensation expense as described above.

Since inception we have incurred significant losses resulting in an accumulated deficit of approximately \$354.0 million as of September 30, 2006. Our operating history and our business risks, including those risks set forth under the caption *Quantitative and Qualitative Disclosures About Market Risk*, in Part I, Item 3., under the caption *Risk Factors* in Part II, Item 1A. and in our other filings with the SEC make the prediction of future results of operations difficult. As a result, we cannot assure you that we will sustain revenue growth or profitability.

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

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

Table of Contents**Liquidity and Capital Resources**

The following tables present key components of our liquidity and capital resources for the third quarter and first three quarters of 2006 and 2005 and at September 30, 2006 and December 31, 2005 (in thousands):

	Nine Months Ended			
	September 30,			
	2006	2005	Change	% Change
Operating cash flows	\$ (107)	\$ (2,460)	\$ 2,353	95.7%
Investing cash flows	13,416	(25,889)	39,305	151.8
Financing cash flows	1,112	746	366	49.1
Capital expenditures	961	447	514	115.0
Days sales outstanding in accounts receivable	39	47	(8)	(17.0)
Inventory turns	3.8	4.0	(0.2)	(5.0)

	September 30,			
	2006		December 31,	
	2006	2005	Change	% Change
Cash and cash equivalents	\$ 19,602	\$ 5,068	\$ 14,534	286.8%
Short-term investments	62,773	77,120	(14,347)	(18.6)
Total	\$ 82,375	\$ 82,188	\$ 187	0.2%
Accounts receivable, net	7,637	5,911	1,726	29.2
Inventories	9,134	7,944	1,190	15.0
Working capital	93,125	88,494	4,631	5.2

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

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

In the first three quarters of 2006 and 2005, our primary source of cash for financing activities was the exercise of employee stock options and shares purchased under our Employee Stock Purchase Plan.

We consider highly liquid investments with original maturities of three months or less at date of purchase to be cash equivalents. We generally consider investments with original maturities greater than three months but less than twelve months to be short-term. In addition, auction-rate securities in established markets, which are available to support current operations, are recorded as short-term due to their liquidity although their contractual maturities are greater than 10 years. We consider other investments with original maturities greater than twelve months to be long term. Cash and cash equivalents consist of bank deposits and money market funds. Our investments, which consist of corporate debt securities and other debt securities issued by United States government and state agencies, including auction-rate securities, are comprised of high-quality securities purchased in accordance with our investment policy. The carrying value of our investments approximates their fair values. Our investments are reviewed periodically for other-than-temporary impairment. At September 30, 2006, the unamortized discounts on our investments were insignificant. In the aggregate, our cash, cash equivalents and short-term investments increased by approximately \$0.2 million during the first three quarters of 2006 as a result of improved cash operating results and changes in working capital. We currently have no long-term debt. See Note 1, Summary of Significant Accounting Policies, to the Notes to Unaudited Consolidated Financial Statements.

Edgar Filing: MICROTUNE INC - Form 10-Q

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

Table of Contents**Future Contractual Commitments***Lease Commitments*

In the normal course of business, we may enter into leases for new or expanded facilities in both domestic and foreign locations. In April 2005, we extended our operating lease for our corporate headquarters in Plano, Texas an additional 10 years reducing the monthly base rent and providing a leasehold improvement allowance. This lease extension also included a brief rent abatement and escalating rent payments and provided for certain rights of early termination with corresponding penalties. Rent expense will be calculated using the straight-line method over the lease term. We lease an administrative, sales and marketing, and research and development facility in Germany under an operating lease with a twenty-two year term, which began in December 1999. We also lease certain other facilities and equipment under operating leases. Future minimum lease payments required under operating leases as of September 30, 2006 are as follows (in thousands):

Year Ending December 31,	
2006	\$ 295
2007	1,055
2008	909
2009	834
2010	830
Thereafter	6,331
	\$ 10,254

Rent expense for the third quarter of 2006 and 2005 was \$0.3 million and \$0.3 million, respectively. Rent expense for the first three quarters of 2006 and 2005 was \$1.0 million and \$0.9 million, respectively.

Purchase Commitments

As of January 15, 2007, we had approximately \$14.2 million of cancelable and non-cancelable purchase commitments outstanding with our vendors. These commitments were entered into in the normal course of business.

Other Commitments

We are currently subject to line down clauses in contracts with certain customers. Such clauses require us to pay financial penalties if our failure to supply product in a timely manner causes the customer to slow down or stop their production. We are also subject to product liability clauses and/or intellectual property indemnification clauses in some of our customer contracts. Such clauses require us to pay financial penalties if we supply defective product, which results in financial damages to the customer, or to indemnify the customer for third-party actions based on the alleged infringement by our product of a third party's intellectual property. As of September 30, 2006, we are unaware of any such claims by any of our customers.

See Note 8, Commitments and Contingencies, to the Notes to Unaudited Consolidated Financial Statements.

CRITICAL ACCOUNTING POLICIES

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

Table of Contents

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

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

Revenue Recognition

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

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

For certain of our customers, we do not recognize revenue until receipt of payment because collection is not probable or the amount we will ultimately collect is not determinable at the date of the shipment. Upon shipment of product to these customers, title to the inventory transfers to the customer and the customer is invoiced. We account for these transactions by recording accounts receivable for the revenue value of the shipments, as the shipments represent valid receivables, and reducing inventory for the cost of the inventory shipped. The difference, representing the gross margin on the transactions, is recorded as deferred revenue. For financial statement presentation purposes, this deferred revenue balance is offset against the corresponding accounts receivable balance from the customer. When payment is received for the transaction, revenue is recognized for the value of the cash payment, cost of revenue is recorded for the cost of the inventory and the deferred revenue is relieved for the gross margin on the transaction. At September 30, 2006 and December 31, 2005, the sales value of products shipped for which revenue was deferred was approximately \$0.1 million and \$0.2 million, respectively. All of the revenue deferred at December 31, 2005 was recognized during the first quarter of 2006.

When we defer revenue, the timing and amount of revenue we ultimately recognize is determined upon our receipt of payment, which can result in significant fluctuations in revenue from period to period. In the third quarter of 2006 and 2005, we recognized 1% and 2%, respectively, of our net revenue upon receipt of payment. In the first three quarters of 2006 and 2005, we recognized 5% and 5%, respectively, of our net revenue upon receipt of payment.

We also defer revenue when customers have made payments and we have not completed the earnings process. These payments are reflected as liabilities in our financial statements as deferred revenue. In these instances, we recognize revenue once the product is shipped, title has transferred to our customer and the earnings process is complete. Deferred revenue as a result of customer prepayments was insignificant as of September 30, 2006 and December 31, 2005.

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

Table of Contents

Allowance for Doubtful Accounts

We evaluate the collectibility of our accounts receivable based on several factors. In circumstances where we are aware of a specific customer's inability to meet its financial obligations to us, we record a specific allowance for bad debts against amounts due to us and reduce the net recorded receivable to the amount we reasonably believe will be collected. We also consider recognizing allowances for doubtful accounts based on the length of time the receivables are outstanding compared to contractual terms, industry and geographic concentrations, the current business environment and our historical experience. Accounts receivable included in the allowance for doubtful accounts are written-off after final collection efforts are exhausted. If the financial condition of our customers deteriorates or if economic conditions worsen, increases in the allowance may be required in the future. We cannot predict future changes in the financial stability of our customers, and there can be no assurance that our allowance will be adequate. Actual credit losses for the third quarter and first three quarters of 2006 and 2005 were insignificant. No allowance for doubtful accounts was recorded as of September 30, 2006 and December 31, 2005.

Inventory Valuation

Our inventories are stated at the lower of standard cost, which approximates actual cost, or estimated realizable value. Amounts are removed from inventory using the first-in, first-out (FIFO) method. Adjustments to reduce our inventories to estimated realizable value, including allowances for excess and obsolete inventories, are determined quarterly by comparing inventory levels of individual materials and parts to current demand forecasts for those items. Actual amounts realized upon the sale of inventories may differ from estimates used to determine inventory valuation allowances due to changes in customer demand, technology changes and other factors. The net impact of changes in the inventory valuation allowances for the third quarter of 2006 and 2005 was a benefit to cost of revenue of approximately \$0.4 million and \$(0.1) million, respectively. The net impact of changes in the inventory valuation allowances for the first three quarters of 2006 was insignificant. The net impact of changes in the inventory valuation allowances for the first three quarters 2005 was a benefit to cost of revenue of approximately \$0.2 million.

Income Taxes

Our income taxes are computed using the asset and liability method of accounting. Under the asset and liability method, a deferred tax asset or liability is recognized for estimated future tax effects attributable to temporary differences and carryforwards. The measurement of deferred income tax assets is adjusted by a valuation allowance, if necessary, to recognize future tax benefits only to the extent, based on available evidence, that it is more likely than not that such benefits will be realized. Our deferred tax assets were fully reserved at September 30, 2006 and December 31, 2005.

We have established a valuation allowance to fully reserve our net deferred tax assets at September 30, 2006 and December 31, 2005 due to the uncertainty of the timing and amount of future taxable income. During 2005, we adjusted our deferred tax assets and liabilities based on the completion of certain reconciliations and accordingly recorded a corresponding adjustment to our valuation allowance. For United States federal income tax purposes, at December 31, 2005, we had a net operating loss carryforward of approximately \$169.0 million and an unused research and development credit carryforward of approximately \$4.4 million, that will begin to expire in 2011. If we generate United States taxable income in future periods, reversal of this valuation allowance could have a significant positive impact on net income in the period that it becomes more likely than not that the deferred tax assets will be utilized. A change in ownership, as defined in Section 382 of the Internal Revenue Code, may limit utilization of the United States federal net operating loss and research and development credit carryforwards.

Table of Contents**Stock-Based Compensation**

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

We adopted SFAS No. 123(R) using the modified-prospective-transition method. Under this transition method, stock-based compensation expense recognized after the effective date includes: (1) compensation cost for all share-based payments granted prior to, but not yet vested as of January 1, 2006, based on the grant date fair value estimate in accordance with the original provisions of SFAS No. 123, and (2) compensation cost for all share-based payments granted subsequent to January 1, 2006, based on the grant-date fair value estimate in accordance with the provisions of SFAS No. 123(R). Results from prior periods have not been restated and do not include the impact of SFAS No. 123(R). Stock-based compensation expense under SFAS No. 123(R) for the third quarter and first three quarters of 2006 was \$1.7 million and \$4.6 million, respectively, relating to employee and director stock options, restricted stock units and our employee stock purchase plan. Stock-based compensation expense under the provisions of APB No. 25 was \$0.3 million and \$0.6 million, respectively, for the third quarter and first three quarters of 2005.

Stock-based compensation expense recognized each period is based on the value of the portion of share-based payment awards that is ultimately expected to vest during the period. SFAS No. 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. In our pro forma disclosures required under SFAS No. 123 for periods prior to 2006, we accounted for forfeitures as they occurred.

Upon adoption of SFAS No. 123(R), we elected to use the Black-Scholes-Merton option-pricing formula to value share-based payments granted to employees subsequent to January 1, 2006 and elected to attribute the value of stock-based compensation to expense using the straight-line single option method. These methods were previously used for our pro forma information required under SFAS No. 123.

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

Prior to the adoption of SFAS No. 123(R), all tax benefits of deductions resulting from the exercise of stock options were required to be presented as operating cash flows in the Consolidated Statement of Cash Flows. SFAS No. 123(R) requires the cash flows resulting from the tax benefits resulting from tax deductions in excess of the compensation cost recognized for those options (excess tax benefits) to be classified as financing cash flows. Due to our historical net operating loss position, we have not recorded these excess tax benefits as of September 30, 2006.

At September 30, 2006, we have five stock-based compensation plans covering employees and directors, including four stock option plans and our employee stock purchase plan. During the third quarter of 2006, we granted our employees approximately 410,000 stock options with exercise prices ranging from \$5.62 to \$6.15 per share. The stock options generally vest over the following three to five years. The weighted-average estimated value of the stock options granted during the third quarter of 2006 was \$3.12 per share, using the Black-Scholes-Merton option-pricing formula with the following weighted-average assumptions:

	Three Months Ended	Nine Months Ended
	September 30,	September 30,
	2006	2006
Expected volatility	57.8%	60.3%
Risk-free interest rate	5.1%	4.8%
Expected dividends	0.0%	0.0%

Table of Contents

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2006		2006	
Expected term (years)	5.0		5.0	

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

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

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

During the second quarter of 2006, our Board of Directors approved an executive bonus program for the year 2006 (2006 Executive Bonus Plan) covering executive officers and providing for bonus compensation, to the extent any such compensation is earned, to be paid exclusively through the performance vesting of restricted stock units under the 2000 Stock Plan. An aggregate of 93,000 restricted stock units were awarded under the 2006 Executive Bonus Plan. The number of total restricted stock units that will ultimately vest and result in the issuance of underlying shares to the executive officers is calculated based on certain scoring factors, as defined in the Plan, including net revenue and adjusted profitability for 2006 and the achievement of certain business goals as of December 31, 2006. The vesting of the restricted stock units will be determined and the issuance of the underlying shares will occur during the first quarter of 2007. Any portion of the restricted stock units that do not vest will immediately be forfeited and returned to the 2000 Stock Plan. The value of the restricted stock units granted during the second quarter of 2006 was \$6.40 per unit using our closing stock-price on the grant date. During the third quarter of 2006, we recognized approximately \$0.2 million of stock-based compensation expense as a result of this plan.

Our Employee Stock Purchase Plan has been deemed compensatory in accordance with SFAS No. 123(R). Stock-based compensation relating to this plan was estimated using a Black-Scholes-Merton option-pricing formula with assumptions previously disclosed under SFAS No. 123 as of the respective grant dates of the purchase rights provided to employees under the plan. The weighted-average estimated value of the purchase rights existing under this plan during the third quarter and first three quarters of 2006 was \$1.98 and \$2.01 respectively. During the third quarter and first three quarters of 2006, we recognized approximately \$0.1 million and \$0.4 million, respectively, of stock-based compensation expense as a result of this plan.

At September 30, 2006, the balance of unearned stock-based compensation to be expensed in future periods related to unvested share-based awards, as adjusted for expected forfeitures, is approximately \$9.9 million. The weighted-average period over which the unearned stock-based compensation is expected to be recognized is approximately 1.7 years. We anticipate that we will grant additional share-based awards to employees in the future, which will increase the stock-based compensation expense by the additional unearned compensation resulting from these grants. The fair value of these grants is not included in the amount above, as the impact of these grants cannot be predicted at this time because it will depend on the number of share-based payments granted. In addition, if factors change and we employ different assumptions in the application of SFAS No. 123(R) in future periods, the stock-based compensation expense that we record under SFAS No. 123(R) may differ significantly from what we have recorded in the current period.

Commitments and Contingencies

We may be subject to the possibility of loss contingencies for various legal matters. Our discussion of legal matters includes pending litigation and matters in which any party has manifested a present intention to commence litigation related to such matters. There can be no assurance that additional contingencies of a legal nature or having legal aspects will not be asserted in the future. Such matters could relate to prior transactions or events or future transactions and events. See Note 8, *Commitments and Contingencies* to the Notes to Unaudited Consolidated Financial Statements. We regularly evaluate current information available to us to determine whether any provisions for loss should be made. If we ultimately determine that a provision for loss should be made for a legal matter, the provision for loss could have a material and adverse effect on our operating results and financial position.

Table of Contents

Our future cash commitments are primarily for long-term facility leases. In April 2005, we extended our operating lease for our corporate headquarters in Plano, Texas an additional 10 years with certain rights of early termination with corresponding penalties, reducing the monthly base rent and providing a leasehold improvement allowance. This lease extension also included a brief rent abatement and escalating rent payments. Our lease for our Germany facility features an option to purchase the facility during certain time periods during the lease. The lease has a twenty-two year term, which began in December 1999. See Note 8, *Commitments and Contingencies* to the Notes to Unaudited Consolidated Financial Statements.

OTHER FINANCIAL INFORMATION

Subsystem Module Manufacturing Partner

On May 24, 2005, we entered into a five-year Manufacturing Agreement with Ionics EMS, Inc. (Ionics), a leading provider of electronics manufacturing services in the Philippines. Ionics replaced TFS as our RF subsystem module manufacturing partner. See Note 3 *Subsystem Module Manufacturing Partner* to the Notes to Unaudited Consolidated Financial Statements.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

There have been no significant changes to the financial information required under this Item 3 from what was disclosed in our amended Annual Report on Form 10-K/A for the fiscal year ended December 31, 2005.

ITEM 4. CONTROLS AND PROCEDURES

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

Changes in Internal Control over Financial Reporting. There has been no change in our internal control over financial reporting that occurred during the quarter ended September 30, 2006 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

For a discussion of remedial measures we took in response to internal control deficiencies related to our stock option grant practices, please see Item 4, *Controls and Procedures*, of our Quarterly Report on Form 10-Q for the quarter ended June 30, 2006, filed contemporaneously herewith and incorporated herein by reference.

Table of Contents

PART II.

OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

The information set forth under the heading *Legal Proceedings* in Note 8 of Notes to Unaudited Consolidated Financial Statements, included in Part I, Item 1. of this Report, is incorporated herein by reference.

See Note 2 to the Notes to Consolidated Financial Statements for more information about legal proceedings.

ITEM 1A. RISK FACTORS

Our amended Annual Report on Form 10-K/A for the fiscal year ended December 31, 2005 (2005 10-K/A) includes a detailed discussion of our risk factors and our amended Quarterly Report on Form 10-Q/A for the quarter ended March 31, 2006 (First Quarter 10-Q/A) and Quarterly Report on Form 10-Q for the quarter ended June 30, 2006 (Second Quarter 10-Q) include material amendments and updates to certain of these risk factors and incorporates additional risk factors not included in our 2005 10-K/A.

The information presented below sets forth material changes from the risk factors previously disclosed in our 2005 10-K/A and First Quarter 10-Q/A. The description of these material changes does not represent a comprehensive list of risk factors that could cause our actual results to differ from those that are currently anticipated and therefore should be read in conjunction with the risk factors and other information disclosed in our 2005 10-K/A, First Quarter 10-Q/A and our other filings with the SEC.

The risk factor set forth immediately below has been added to describe risks related to our stock option grant practices and restatement.

The matters relating to the investigation by the Audit Committee of our Board of Directors into our stock option granting practices and the restatement of our consolidated financial statements may result in future litigation or regulatory inquiries which could harm our financial results.

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

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

This review of our historical stock option granting practices has required us to incur substantial expenses for legal, accounting, tax and other professional services, has diverted our management's attention from our business, and could in the future adversely affect our business, financial condition, results of operations and cash flows.

Our historical stock option granting practices and the restatement of our prior financial statements have exposed us to greater risks associated with litigation and regulatory proceedings. We cannot assure you that any future litigation or regulatory action will result in the same conclusions reached by the Audit Committee. The conduct and resolution of these matters will be time consuming, expensive and distracting from the conduct of our business.

We voluntarily contacted the SEC regarding the Audit Committee's investigation and our representatives expect to meet with the SEC to discuss the findings of the Audit Committee's investigation in detail. We intend to cooperate with the SEC in any investigation into these matters.

Table of Contents

While we believe that we have made appropriate judgments in concluding the correct measurement dates for stock option grants, the SEC may also disagree with the manner in which we have accounted for and reported, or not reported, the financial impact of past stock option grant measurement date errors, and there is a risk that any SEC inquiry could lead to circumstances in which we may have to further restate our prior financial statements, amend prior SEC filings, or otherwise take other actions not currently contemplated. Any such circumstance could also lead to future delays in filing our subsequent SEC reports and delisting of our common stock from The NASDAQ Global Market. Furthermore, if we are subject to adverse findings in any of these matters, we could be required to pay damages or penalties or have other remedies imposed upon us which could harm our business, financial condition, results of operations and cash flows. Please see Note 2 of the Notes to Consolidated Financial Statements for further information.

The risk factor set forth immediately below has been modified to describe risks related to new technological requirements of the mobile TV market segment:

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

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

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

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

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

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

the risk that products that we develop with a partner, such as a SIP or SOC, will not be available on a timeframe acceptable to mobile phone manufacturers or may not meet necessary performance levels or cost targets;

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

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

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

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

Edgar Filing: MICROTUNE INC - Form 10-Q

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

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

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

Table of Contents

the risk that multi-standard, poly-band, universal TV tuners will be preferred by mobile phone manufacturers and our multi-standard, poly-band, universal TV tuners may not meet performance expectations or be available in the necessary timeframe. To the extent our efforts to penetrate the mobile TV market segment are adversely affected by any of these risks or are otherwise unsuccessful, we could experience a material adverse effect on our business prospects, financial condition and results of operations.

The risk factor set forth immediately below has been modified to describe risks related to competition by module tuner suppliers, our inability to meet customer performance requirements, the timing of open customer design windows and new technological requirements:

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

The market for digital TV applications in televisions, digital TV set-top converter boxes and television peripherals is characterized by various market-specific risks, any of which may adversely affect our ability to compete in that market.

Examples of market-specific risks affecting this market segment include:

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

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

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

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

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

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

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

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

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

the risk that multi-standard, poly-band, universal TV tuners will be preferred by digital TV manufacturers and our multi-standard, poly-band, universal TV tuners may not meet performance expectations or be available in the necessary timeframe. Our efforts to penetrate the digital TV market, in particular, will depend on our ability to overcome the challenges described above and upon eventual acceptance of our new digital TV products, such as the MT2131. To the extent our efforts are adversely affected by any of these risks or are otherwise unsuccessful, we could experience a material adverse effect on our business prospects, financial condition and results of operations.

Table of Contents

The risk factor set forth immediately below has been added to describe risks related to our design-in activities and customer design windows:

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

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

The risk factor set forth immediately below has been added to describe risks related to our ability to retain key personnel and our ability to attract and retain qualified engineering personnel:

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

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

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

Additionally, if we do not meet our hiring targets, we may be unable to support our key prospective customers and we may lose the ability to enter large emerging markets, resulting in a material adverse effect on our future prospects. We rely heavily upon equity compensation incentives, such as options to purchase our common stock to attract, retain and motivate such personnel. The equity incentives of our competitors and other elements of our competitors' compensation structures, particularly cash compensation, may be significantly more attractive than the compensation packages we offer.

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

Additionally, we may have to explore the possibility of opening design centers in locations where attractive candidates prefer to live. We opened a design center in Plantation, Florida in February 2006 and in Longmont, Colorado in September 2006 in order to acquire additional engineering talent. To the extent we pursue the strategy of opening additional remote locations, our cost structure may increase at a higher rate than if attractive candidates were employed at existing facilities.

Table of Contents

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

The risk factor set forth immediately below has been modified to describe risks related to the difficulty experienced by our customers in forecasting the demand for their new products, which could cause our quarterly results to fluctuate:

We expect our quarterly results of operations to continue to fluctuate.

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

the timing, cancellation and rescheduling of significant customer orders;

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

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

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

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

design wins and changes in our product and customer mix;

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

problems with our products that result in significant returns;

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

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

Edgar Filing: MICROTUNE INC - Form 10-Q

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

acts of God or force majeure.

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

ITEM 6. EXHIBITS

Exhibit

Number

- | | |
|---------------------|---|
| 3.1 ⁽¹⁾ | Restated Certificate of Incorporation filed with the Secretary of State of the State of Delaware on May 25, 2005. |
| 3.2 ⁽¹⁾ | Third Amended and Restated Bylaws, as amended April 13, 2005. |
| 10.1 ⁽²⁾ | Indemnification Agreement between the Company and Michael T. Schueppert dated August 21, 2006. |

Table of Contents

- 31.1 Certification of Chief Executive Officer under Section 302 of the Sarbanes-Oxley Act of 2002.
 - 31.2 Certification of Principal Financial Officer under Section 302 of the Sarbanes-Oxley Act of 2002.
 - 32.1 Certification of Chief Executive Officer under Section 906 of the Sarbanes-Oxley Act of 2002.
 - 32.2 Certification of Principal Financial Officer under Section 906 of the Sarbanes-Oxley Act of 2002.
-

- (1) Incorporated by reference to the Registrant's Current Report on Form 8-K filed on May 31, 2005.
- (2) Incorporated by reference to the Registrant's Current Report on Form 8-K filed on August 22, 2006.

Table of Contents

SIGNATURE

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

MICROTUNE, INC.

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

Chief Financial Officer

(Principal Financial Officer and Principal

Accounting Officer)

Date: January 22, 2007