

SILICON LABORATORIES INC  
Form 10-Q  
July 25, 2007

# UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

## FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2007

Or

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number: 000-29823

## SILICON LABORATORIES INC.

(Exact name of registrant as specified in its charter)

**Delaware**

(State or other jurisdiction of incorporation or organization)

**400 West Cesar Chavez, Austin, Texas**  
(Address of principal executive offices)

**74-2793174**

(I.R.S. Employer Identification No.)

**78701**  
(Zip Code)

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(512) 416-8500

(Registrant's telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Sections 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 July 18, 2007, 55,205,960 shares of common stock of Silicon Laboratories Inc. were outstanding.

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Cautionary Statement

*Except for the historical financial information contained herein, the matters discussed in this report on Form 10-Q (as well as documents incorporated herein by reference) may be considered forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Such forward-looking statements include declarations regarding the intent, belief or current expectations of Silicon Laboratories Inc. and its management and may be signified by the words expects, anticipates, intends, believes or similar language. You are cautioned that any such forward-looking statements are not guarantees of future performance and involve a number of risks and uncertainties. Actual results could differ materially from those indicated by such forward-looking statements. Factors that could cause or contribute to such differences include those discussed under Risk Factors and elsewhere in this report. Silicon Laboratories disclaims any intention or obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.*

**Part I. Financial Information****Item 1. Financial Statements****Silicon Laboratories Inc.****Condensed Consolidated Balance Sheets****(In thousands, except per share data)****(Unaudited)**

	<b>June 30, 2007</b>	<b>December 30, 2006</b>
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 162,066	\$ 68,188
Short-term investments	481,930	318,104
Accounts receivable, net of allowance for doubtful accounts of \$501 at June 30, 2007 and \$421 at December 30, 2006	42,171	36,657
Inventories	18,982	22,016
Deferred income taxes	5,229	12,118
Prepaid expenses and other	31,989	12,944
Current assets of discontinued operations		33,680
Total current assets	742,367	503,707
Property, equipment and software, net	29,824	34,070
Goodwill	65,519	65,680
Other intangible assets, net	18,109	20,271
Other assets, net	24,070	24,528
Non-current assets of discontinued operations		38,739
Total assets	\$ 879,889	\$ 686,995
<b>Liabilities and Stockholders Equity</b>		
Current liabilities:		
Accounts payable	\$ 30,051	\$ 26,438
Accrued expenses	18,148	23,051
Deferred income on shipments to distributors	18,341	20,568
Income taxes		15,063
Current liabilities of discontinued operations	10,099	16,502
Total current liabilities	76,639	101,622
Long-term obligations and other liabilities	49,641	15,641
Non-current liabilities of discontinued operations		1,050
Total liabilities	126,280	118,313
Commitments and contingencies		
Stockholders equity:		
Preferred stock \$0.0001 par value; 10,000 shares authorized; no shares issued and outstanding		
Common stock \$0.0001 par value; 250,000 shares authorized; 55,114 and 54,802 shares issued and outstanding at June 30, 2007 and December 30, 2006, respectively	6	5
Additional paid-in capital	395,495	373,655
Retained earnings	358,108	195,022
Total stockholders equity	753,609	568,682
Total liabilities and stockholders equity	\$ 879,889	\$ 686,995

*The accompanying notes are an integral part of these Condensed Consolidated Financial Statements.*



## Silicon Laboratories Inc.

## Condensed Consolidated Statements of Income

(In thousands, except per share data)

(Unaudited)

	Three Months Ended		Six Months Ended	
	June 30, 2007	July 1, 2006	June 30, 2007	July 1, 2006
Revenues	\$ 75,597	\$ 73,936	\$ 149,411	\$ 140,588
Cost of revenues	30,233	24,442	58,672	45,569
Gross profit	45,364	49,494	90,739	95,019
Operating expenses:				
Research and development	22,145	22,619	46,952	43,688
Selling, general and administrative	21,282	22,822	45,574	43,552
In-process research and development		2,600		2,600
Operating expenses	43,427	48,041	92,526	89,840
Operating income (loss)	1,937	1,453	(1,787)	5,179
Other income (expense):				
Interest income	7,032	3,624	10,867	6,826
Interest expense	(167)	(225)	(398)	(400)
Other income (expense), net	(51)	45	(170)	291
Income from continuing operations before income taxes	8,751	4,897	8,512	11,896
Provision for income taxes	1,859	1,892	2,366	3,693
Income from continuing operations	6,892	3,005	6,146	8,203
Income from discontinued operations, net of income taxes	581	7,132	156,940	12,998
Net income	\$ 7,473	\$ 10,137	\$ 163,086	\$ 21,201
Basic earnings per share:				
Income from continuing operations	\$ 0.13	\$ 0.05	\$ 0.11	\$ 0.15
Net income	\$ 0.14	\$ 0.18	\$ 2.97	\$ 0.38
Diluted earnings per share:				
Income from continuing operations	\$ 0.12	\$ 0.05	\$ 0.11	\$ 0.14
Net income	\$ 0.13	\$ 0.18	\$ 2.90	\$ 0.37
Weighted-average common shares outstanding:				
Basic	54,901	55,842	54,856	55,460
Diluted	56,312	57,858	56,308	57,761

The accompanying notes are an integral part of these Condensed Consolidated Financial Statements.

## Silicon Laboratories Inc.

## Condensed Consolidated Statements of Cash Flows

(In thousands)

(Unaudited)

	Six Months Ended	
	June 30, 2007	July 1, 2006
<b>Operating Activities</b>		
Net income	\$ 163,086	\$ 21,201
Adjustments to reconcile net income to cash provided by operating activities:		
Income from discontinued operations	(156,940 )	(12,998 )
Depreciation and amortization of property, equipment and software	5,794	7,113
Loss (gain) on disposal of property, equipment and software	187	(129 )
Amortization of other intangible assets and other assets	2,450	2,145
Stock compensation expense	20,390	15,625
In-process research and development		2,600
Additional income tax benefit from employee stock-based awards	1,106	9,724
Excess income tax benefit from employee stock-based awards	(782 )	(5,509 )
Changes in operating assets and liabilities:		
Accounts receivable	(5,514 )	(5,368 )
Inventories	3,213	(5,544 )
Prepaid expenses and other assets	1,848	(11,440 )
Accounts payable	(594 )	11,861
Accrued expenses	(7,908 )	2,355
Deferred income on shipments to distributors	(2,227 )	2,788
Deferred income taxes	2,639	(2,617 )
Income taxes	(43,361 )	(236 )
Net cash provided by (used in) operating activities of continuing operations	(16,613 )	31,571
<b>Investing Activities</b>		
Purchases of short-term investments	(301,640 )	(120,506 )
Sales and maturities of short-term investments	137,814	155,948
Purchases of property, equipment and software	(1,735 )	(5,742 )
Proceeds from sales of assets	270,750	839
Purchases of other assets	(345 )	(3,513 )
Acquisition of businesses, net of cash acquired		(16,011 )
Net cash provided by investing activities of continuing operations	104,844	11,015
<b>Financing Activities</b>		
Proceeds from Employee Stock Purchase Plan	1,399	1,228
Proceeds from exercises of stock options	5,802	27,436
Excess income tax benefit from employee stock-based awards	782	5,509
Repurchases of common stock	(18,474 )	
Payments on debt		(774 )
Net cash provided by (used in) financing activities of continuing operations	(10,491 )	33,399
<b>Discontinued Operations</b>		
Operating activities	11,004	3,151
Investing activities	(1,654 )	(4,899 )
Financing activities	6,788	4,464
Net cash provided by discontinued operations	16,138	2,716
Increase in cash and cash equivalents	93,878	78,701
Cash and cash equivalents at beginning of period	68,188	100,504
Cash and cash equivalents at end of period	\$ 162,066	\$ 179,205
<b>Supplemental Disclosure of Cash Flow Information:</b>		
Interest paid	\$ 617	\$ 336
Income taxes paid	\$ 42,834	\$ 5,680
<b>Supplemental Disclosure of Non-Cash Activity:</b>		

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Proceeds from the sale of assets held in escrow	\$	14,250	\$	
Receivable for sale of property, equipment and software	\$		\$	1,381

*The accompanying notes are an integral part of these Condensed Consolidated Financial Statements.*



## Silicon Laboratories Inc.

## Notes to Condensed Consolidated Financial Statements

(Unaudited)

**1. Significant Accounting Policies***Basis of Presentation and Principles of Consolidation*

The condensed consolidated financial statements included herein are unaudited; however, they contain all normal recurring accruals and adjustments which, in the opinion of management, are necessary to present fairly the condensed consolidated financial position of Silicon Laboratories Inc. and its subsidiaries (collectively, the Company) at June 30, 2007 and December 30, 2006, the condensed consolidated results of its operations for the three and six months ended June 30, 2007 and July 1, 2006, and the condensed consolidated statements of cash flows for the six months ended June 30, 2007 and July 1, 2006. All intercompany balances and transactions have been eliminated. The condensed consolidated results of operations for the three and six months ended June 30, 2007 are not necessarily indicative of the results to be expected for the full year.

The accompanying unaudited condensed consolidated financial statements do not include certain footnotes and financial presentations normally required under U.S. generally accepted accounting principles. Therefore, these condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto for the year ended December 30, 2006, included in the Company's Form 10-K filed with the Securities and Exchange Commission (SEC) on February 7, 2007.

*Reclassifications*

A portion of the Company's sales are made to distributors under agreements allowing for price protection. The Company defers revenue and the related costs on such sales until the distributors sell the product to the end customer. The Company has reclassified estimated credits for price protection in prior periods to conform to the current year presentation. Accordingly, the Company has reclassified estimated credits for price protection in its condensed consolidated statement of cash flows for the six months ended July 1, 2006, which affected cash flows as follows (in thousands):

	<b>July 1, 2006</b>
Accounts receivable	\$ 323
Accrued expenses	(639 )
Deferred income on shipments to distributors	\$ 316

The reclassifications had no impact on the Company's results of operations or its overall cash flows from operating activities in its condensed consolidated statements of cash flows.

**Silicon Laboratories Inc.**

**Notes to Condensed Consolidated Financial Statements (Continued)**

**(Unaudited)**

*Comprehensive Income*

Comprehensive income consists of net income and net unrealized gains (losses) on available-for-sale investments. There were no significant differences between net income and comprehensive income during any of the periods presented.

*Recent Accounting Pronouncements*

In February 2007, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) 159, *The Fair Value Option for Financial Assets and Financial Liabilities* Including an amendment of FASB Statement No. 115. SFAS 159 expands the use of fair value accounting to many financial instruments and certain other items. The fair value option is irrevocable and generally made on an instrument-by-instrument basis, even if a company has similar instruments that it elects not to measure based on fair value. SFAS 159 is effective for fiscal years beginning after November 15, 2007. The Company is currently evaluating the effect that the adoption of SFAS 159 will have on its financial position and results of operations.

In September 2006, the FASB issued SFAS 157, *Fair Value Measurements*. SFAS 157 defines fair value, establishes a framework for measuring fair value in GAAP and expands disclosures about fair value measurements. SFAS 157 is effective for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. The Company is currently evaluating the effect that the adoption of SFAS 157 will have on its financial position and results of operations.

**2. Discontinued Operation**

On February 8, 2007, the Company entered into a Sale and Purchase Agreement ( *Purchase Agreement* ) pursuant to which it sold its Aero® transceiver, AeroFONE single-chip phone and power amplifier product lines (the *Aero product lines* ) to NXP B.V. and NXP Semiconductors France SAS (collectively *NXP* ) in exchange for \$285 million in cash, including \$14.3 million held in escrow, with additional earn-out potential of up to an aggregate of \$65 million over the next three years. The sale was completed on March 23, 2007.

## Silicon Laboratories Inc.

## Notes to Condensed Consolidated Financial Statements (Continued)

(Unaudited)

The financial results of the sold product lines have been presented as discontinued operations in the condensed consolidated financial statements. As a result, the footnote disclosures have also been revised to exclude amounts related to the discontinued operations. The following summarizes results from the discontinued operations (in thousands, except per share data):

	Three Months Ended		Six Months Ended	
	June 30, 2007	July 1, 2006	June 30, 2007	July 1, 2006
Revenues	\$ 5,178	\$ 49,568	\$ 43,166	\$ 97,456
Costs of revenues and operating expenses	4,485	39,744	41,176	80,376
	693	9,824	1,990	17,080
Gain on sale of discontinued operations	86		222,424	
Income from discontinued operations before income taxes	779	9,824	224,414	17,080
Provision for income taxes	198	2,692	67,474	4,082
Income from discontinued operations, net of income taxes	\$ 581	\$ 7,132	\$ 156,940	\$ 12,998
Income from discontinued operations per common share:				
Basic	\$ 0.01	\$ 0.13	\$ 2.86	\$ 0.23
Diluted	\$ 0.01	\$ 0.12	\$ 2.79	\$ 0.23
Weighted-average common shares outstanding:				
Basic	54,901	55,842	54,856	55,460
Diluted	56,312	57,858	56,308	57,761

Current liabilities of discontinued operations consisted of \$10.1 million of accrued expenses at June 30, 2007. In June 2007, the Company made a \$40.0 million estimated tax payment due to the gain on the sale of our Aero product lines.

*Continuing Involvement*

In connection with the closing of the sale, the Company entered into certain ancillary agreements with NXP, including a Transition Services Agreement ( TSA ) and an Intellectual Property License Agreement ( IPLA ). Through the TSA, the Company agreed to sublease certain premises to NXP and to provide various temporary support services, such as IT support services. Such services are expected to be provided for approximately six months from the closing date. The fees for these services will be generally equivalent to the Company's cost. The TSA fees were approximately \$2.0 million for the three months ended June 30, 2007. Through the IPLA, the Company granted NXP a license with respect to retained intellectual property and NXP granted a license to the Company with respect to transferred intellectual property. However, these cross-license agreements do not involve the receipt or payment of any royalties and therefore are not considered to be a component of continuing involvement.

## Silicon Laboratories Inc.

## Notes to Condensed Consolidated Financial Statements (Continued)

## (Unaudited)

Although the services provided under the TSA generate continuing cash flows between the Company and NXP, the amounts are not considered to be significant to the ongoing operations of either entity. In addition, the Company has no contractual ability through the TSA or any other agreement to significantly influence the operating or financial policies of NXP. Under the provisions of EITF Issue No. 03-13,

Applying the Conditions of Paragraph 42 of FASB Statement No. 144 in Determining Whether to Report Discontinued Operations, the Company therefore has no significant continuing involvement in the operations of the former product lines sold to NXP and has classified such operating results as discontinued operations.

**3. Earnings Per Share**

The following table sets forth the computation of basic and diluted earnings per share from continuing operations (in thousands, except per share data):

	Three Months Ended		Six Months Ended	
	June 30, 2007	July 1, 2006	June 30, 2007	July 1, 2006
Income from continuing operations	\$ 6,892	\$ 3,005	\$ 6,146	\$ 8,203
Shares used in computing basic earnings per share	54,901	55,842	54,856	55,460
Effect of dilutive securities:				
Stock options and awards	1,411	2,016	1,452	2,301
Shares used in computing diluted earnings per share	56,312	57,858	56,308	57,761
Income from continuing operations				
Basic earnings per share	\$ 0.13	\$ 0.05	\$ 0.11	\$ 0.15
Diluted earnings per share	\$ 0.12	\$ 0.05	\$ 0.11	\$ 0.14

Approximately 4.1 million, 3.4 million, 4.4 million and 2.9 million weighted-average dilutive potential shares of common stock have been excluded from the earnings per share calculation for the three months ended June 30, 2007 and July 1, 2006, and for the six months ended June 30, 2007 and July 1, 2006, respectively, as they are anti-dilutive. The Company issued 1.0 million shares of common stock and repurchased 0.6 million shares during the six months ended June 30, 2007 as part of the previously announced share repurchase program. Approximately 0.1 million shares were withheld by the Company during the six month period to satisfy employee tax obligations for the vesting of certain stock grants made under the Company's 2000 Stock Incentive Plan.

## Silicon Laboratories Inc.

## Notes to Condensed Consolidated Financial Statements (Continued)

(Unaudited)

**4. Balance Sheet Details***Inventories*

Inventories are stated at the lower of cost, determined using the first-in, first-out method, or market. Inventories (excluding discontinued operations) consist of the following (in thousands):

	June 30, 2007	December 30, 2006
Work in progress	\$ 17,689	\$ 16,332
Finished goods	1,293	5,684
	\$ 18,982	\$ 22,016

*Long-term obligations and other liabilities*

Long-term obligations and other liabilities consist of the following (in thousands):

	June 30, 2007	December 30, 2006
Unrecognized tax benefits	\$ 38,430	\$
Other	11,211	15,641
	\$ 49,641	\$ 15,641

**5. Stock-Based Compensation and Share Repurchase Program****Stock-Based Compensation**

The Company has two stock-based compensation plans, the 2000 Stock Incentive Plan and the Employee Stock Purchase Plan (the Purchase Plan). Effective January 1, 2006, the Company adopted FASB SFAS 123 (revised 2004), Share-Based Payment, (SFAS 123R) using the modified-prospective-transition method.

## Silicon Laboratories Inc.

## Notes to Condensed Consolidated Financial Statements (Continued)

(Unaudited)

*Accounting for Stock Compensation*

Stock-based compensation costs are generally based on the fair value calculated from the Black-Scholes option-pricing model on the date of grant for stock options and on the date of enrollment for the Purchase Plan. Restricted stock unit (RSU) fair values generally equal their intrinsic value on the date of grant. The weighted-average fair value of share-based payments was estimated using the Black-Scholes option-pricing model with the following assumptions:

	Six Months Ended			
	June 30,	July 1,		
	2007	2006		
<b>2000 Stock Incentive Plan:</b>				
Expected volatility	53.0	%	60.8	%
Risk-free interest rate %	4.7	%	4.9	%
Expected term (in years)	4.8		5.0	
Dividend yield				
<b>Employee Stock Purchase Plan:</b>				
Expected volatility	36.7	%	49.7	%
Risk-free interest rate %	4.9	%	4.9	%
Expected term (in months)	15		9	
Dividend yield				

The following are the stock-based compensation costs recognized in the Company's condensed consolidated statements of income (in thousands):

	Three Months Ended		Six Months Ended	
	June 30,	July 1,	June 30,	July 1,
	2007	2006	2007	2006
Cost of revenues	\$ 379	\$ 317	\$ 686	\$ 461
Research and development	4,078	3,187	9,449	6,103
Selling, general and administrative	4,164	4,414	10,256	9,308
	\$ 8,621	\$ 7,918	\$ 20,391	\$ 15,872

The Company recorded \$3.3 million of stock compensation expense in continuing operations during the three months ended March 31, 2007 for a one-time equity award to employees retained by the Company after the sale of the Aero product lines.

The Company recorded an additional \$5.5 million in Income from discontinued operations, net of income taxes during the three months ended March 31, 2007 in connection with modifications of equity grants to employees who were hired by NXP associated with the sale of the Aero product lines. As of the closing date of the sale, the Company accelerated the vesting of 0.5 million shares of options and awards, and extended the exercise period of 0.9 million shares of options through December 31, 2007. Further, the Company cancelled 0.3 million shares of unvested options and awards related to the terminated employees. There were no significant modifications made to any other stock grants during this period.

The Company had approximately \$92.7 million of total unrecognized compensation costs related to stock options and RSUs at June 30, 2007 that are expected to be recognized over a weighted-average period of 2.2 years.



**Silicon Laboratories Inc.**

**Notes to Condensed Consolidated Financial Statements (Continued)**

**(Unaudited)**

**Share Repurchase Program**

In July 2006, the Company's Board of Directors authorized a program to repurchase up to \$100 million of the Company's common stock from time to time over a twelve-month period. The program allowed for repurchases to be made in the open market subject to applicable legal requirements and other factors. As of June 30, 2007, the Company had repurchased 2.2 million shares of its common stock under this plan for \$68.5 million at an average purchase price of \$31.51 per share.

**6. Commitments and Contingencies**

*Securities Litigation*

On December 6, 2001, a class action complaint for violations of U.S. federal securities laws was filed in the United States District Court for the Southern District of New York against the Company, four officers individually and the three investment banking firms who served as representatives of the underwriters in connection with the Company's initial public offering of common stock. The Consolidated Amended Complaint alleges that the registration statement and prospectus for the Company's initial public offering did not disclose that (1) the underwriters solicited and received additional, excessive and undisclosed commissions from certain investors, and (2) the underwriters had agreed to allocate shares of the offering in exchange for a commitment from the customers to purchase additional shares in the aftermarket at pre-determined higher prices. The action seeks damages in an unspecified amount and is being coordinated with approximately 300 other nearly identical actions filed against other companies. A court order dated October 9, 2002 dismissed without prejudice the four officers of the Company who had been named individually. On February 19, 2003, the District Court denied the motion to dismiss the complaint against the Company. On October 13, 2004, the District Court certified a class in six of the approximately 300 other nearly identical actions (the "focus cases") and noted that the decision was intended to provide strong guidance to all parties regarding class certification in the remaining cases. The Underwriter Defendants appealed the decision and a panel of the Second Circuit vacated the District Court's decision granting class certification in those six cases on December 5, 2006. Plaintiffs filed a petition for rehearing on January 5, 2007. On April 6, 2007, the Second Circuit denied the petition for rehearing, but noted that plaintiffs could ask the District Court to certify a more narrow class than the one that was rejected.

Prior to the Second Circuit's decision, the Company had approved a settlement agreement and related agreements which set forth the terms of a settlement between the Company, the purported plaintiff class and the vast majority of the other approximately 300 issuer defendants. These agreements were submitted to the Court for approval. In light of the Second Circuit opinion, the parties agreed that the settlement cannot be approved because the defined settlement class, like the litigation class, cannot be certified. On June 22, 2007, the plaintiffs and the issuers agreed to a stipulation terminating the proposed settlement, subject to court approval. The Court approved the stipulation terminating the settlement on June 25, 2007. The Company cannot predict whether it will be able to renegotiate a settlement that complies with the Second Circuit's mandate. Due to the inherent uncertainties of litigation, the Company cannot accurately predict the ultimate outcome of the matter.

The Company is unable to estimate or predict the potential damages that might be awarded as a result of this litigation, whether such damages would be greater than the Company's insurance coverage, or whether the outcome would have a material impact on the Company's results of operations or financial position.



**Silicon Laboratories Inc.**

**Notes to Condensed Consolidated Financial Statements (Continued)**

**(Unaudited)**

*Patent and Copyright Infringement Litigation*

On December 14, 2006, Analog Devices, Inc. (Analog Devices), a Massachusetts corporation, filed a lawsuit against the Company, in the United States District Court in the District of Massachusetts, alleging infringement of United States Patents 7,075,329, 6,262,600, 6,525,566, 6,903,578 and 6,873,065, and copyright infringement of certain Analog Devices datasheets. On January 31, 2007, the Company filed its answer to Analog Devices' complaint, in which the Company denied infringement and asserted that Analog Devices' patents are invalid. The Company also filed counterclaims in which it alleged that Analog Devices has engaged in unfair competition under both state and federal law. The Court has scheduled a trial date in May 2008. The lawsuit relates to the Company's Si843x and Si844x family of digital isolator products and alleges that the infringement was and continues to be willful. At this time, the Company cannot estimate the outcome of this matter or resulting financial impact to it, if any.

*Other*

The Company is involved in various other legal proceedings that have arisen in the normal course of business. While the ultimate results of these matters cannot be predicted with certainty, the Company does not expect them to have a material adverse effect on the consolidated financial position or results of operations.

*Discontinued Operations Indemnification*

In connection with the sale of the Aero product lines, the Company agreed to indemnify NXP with respect to (a) liabilities for breach of the Company's representations and warranties in the Purchase Agreement, (b) liabilities for breach of the Company's covenants or agreements pursuant to the Purchase Agreement, (c) liabilities of the Company that were not assumed by NXP and (d) liabilities for certain tax matters. With respect to breaches of representations and warranties, the Company's maximum potential exposure is limited to \$14.3 million (the amount of cash proceeds held in escrow). There is no contractual limit on exposure with respect to the other liabilities. As of June 30, 2007, the Company had no material liabilities recorded under these indemnification obligations.

**7. Income Taxes**

The Company adopted FASB Interpretation (FIN) 48, *Accounting for Uncertainty in Income Taxes* at the beginning of fiscal 2007. As a result of the implementation of FIN 48, the Company recognized no change in the liability for unrecognized tax benefits. As of the date of adoption, the Company had \$20.9 million of unrecognized tax benefits, of which \$20.1 million would affect the effective tax rate if recognized. Also as of the date of adoption, it was deemed reasonably possible that the Company would recognize tax benefits in the amount of \$7.0 million in the next twelve months due to the closing of open tax years. The nature of the uncertainty relates to deductions taken on returns that had previously been examined by the applicable tax authority.

At June 30, 2007, the Company had \$38.4 million of unrecognized tax benefits, of which \$37.4 million would affect the effective tax rate if recognized. During the six months ended June 30, 2007, the Company had gross increases of \$18.1 million to its current year unrecognized tax benefits, primarily related to tax consequences associated with discontinued operations. In addition, during the three months ended June 30, 2007, the Company had gross decreases of \$0.5 million to its unrecognized tax benefits for the prior year related to the closure of an income tax audit.

## Silicon Laboratories Inc.

## Notes to Condensed Consolidated Financial Statements (Continued)

(Unaudited)

The Company recognizes interest and penalties related to uncertain tax positions in the provision for income taxes. As of the date of adoption, the Company had accrued approximately \$2.3 million of interest related to uncertain tax positions. During the six months ended June 30, 2007, the Company recognized approximately \$0.5 million of interest, net of tax, in the provision for income taxes. As of June 30, 2007, the Company had accrued approximately \$3.0 million of interest related to uncertain tax positions.

The tax years 2002 through 2006 remain open to examination by the major taxing jurisdictions to which the Company is subject.

**8. Acquisition**Silembia

In May 2006, the Company completed its acquisition of Silembia, a privately held company based in Rennes, France. Silembia developed semiconductor intellectual property for digital demodulation and channel decoding. The Company acquired all of the outstanding capital stock of Silembia in exchange for approximately \$20.5 million, which includes direct acquisition costs. Of such consideration, \$2.8 million was withheld as security for breaches of representations and warranties and certain other expressly enumerated matters. The acquisition was accounted for as a purchase business combination in accordance with SFAS No. 141, Business Combinations (SFAS 141), and accordingly, the results of Silembia's operations are included in the Company's consolidated results of operations from the date of the acquisition. Through the acquisition, the Company acquired engineering expertise and reduced the time required to develop new technologies and products. These factors contributed to a purchase price that was in excess of the fair value of the net assets acquired and, as a result, the Company recorded goodwill. None of the goodwill is deductible for tax purposes. The purchase price was allocated as follows (in thousands):

	Amount	Weighted-Average Amortization Period (Years)
Intangible assets:		
Core & developed technology	\$ 9,400	7.9
Employment-related	100	1.9
In-process research and development	2,600	
	12,100	
Fair value of net tangible assets	(1,463	)
Goodwill	9,883	
Total purchase price	\$ 20,520	

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

*The following discussion and analysis of financial condition and results of operations should be read in conjunction with the condensed consolidated financial statements and related notes thereto included elsewhere in this report. This discussion contains forward-looking statements. Please see the Cautionary Statement above and Risk Factors below for a discussion of the uncertainties, risks and assumptions associated with these statements. Our fiscal year-end financial reporting periods are a 52- or 53- week year ending on the Saturday closest to December 31st. Fiscal 2007 will have 52 weeks. Our second quarter of fiscal 2007 ended June 30, 2007. Our second quarter of fiscal 2006 ended July 1, 2006. All of the quarterly periods reported in this quarterly report on Form 10-Q had thirteen weeks. Except as noted, financial results are for continuing operations. Our former Aero product lines are reported as discontinued operations. The sale of these product lines closed on March 23, 2007.*

## Overview

We design and develop proprietary, analog-intensive, mixed-signal integrated circuits (ICs) for a broad range of applications. Mixed-signal ICs are electronic components that convert real-world analog signals, such as sound and radio waves, into digital signals that electronic products can process. Therefore, mixed-signal ICs are critical components in a broad range of applications in a variety of markets, including communications, consumer, industrial, automotive, medical and power management. Our major customers include 2Wire, Compal, LSI, Motorola, Panasonic, Philips, Sagem, Samsung, Tellabs and Thomson.

As a fabless semiconductor company, we rely on third-party semiconductor fabricators in Asia, and to a lesser extent the United States, to manufacture the silicon wafers that reflect our IC designs. Each wafer contains numerous die, which are cut from the wafer to create a chip for an IC. We rely on third-parties in Asia to assemble, package, and, in the substantial majority of cases, test these devices and ship these units to our customers. We have increased the portion of testing performed by such third parties, which facilitates faster delivery of products to our customers (particularly those located in Asia), shorter production cycle times, lower inventory requirements, lower costs and increased flexibility of test capacity.

Our product set addresses a variety of broad-based mixed-signal applications. Our expertise in analog-intensive, high-performance, mixed-signal ICs enables us to develop highly differentiated solutions that address multiple markets. We group our products into the following categories:

- ISModem® embedded modems;
- Broadcast products, which include our broadcast radio tuners and transmitters, satellite set-top box receivers and satellite radio tuner;
- Voice over IP products, which include our ProSLIC® subscriber line interface circuits and voice direct access arrangement (DAA);
- Microcontrollers;
- Timing products, which include our precision clock & data recovery ICs and oscillators;
- Power products, which include our isolators and Power over Ethernet controller; and
- Mature products, which include our silicon DAA for PC modems, DSL analog front end ICs, optical physical layer transceivers and RF Synthesizers.

Through acquisitions and internal development efforts, we have continued to diversify our product portfolio and introduce next generation ICs with added functionality and further integration. In 2006, we introduced a family of highly integrated FM transmitters, a family of digital isolator products, a Power over Ethernet controller and we expanded our microcontroller portfolio with the addition of new USB microcontrollers, Embedded Ethernet solutions and a family of highly-integrated microcontrollers designed specifically for automotive electronics. In the first six months of 2007, we introduced a fully integrated AM/FM radio receiver, a dual ProSLIC for VoIP equipment and families of jitter-attenuating clock multipliers, single-chip FM radio transceivers and small form factor microcontrollers. We plan to continue to introduce products that increase the content we provide for existing applications and enable us to serve markets we do not currently address, thereby expanding our total available market opportunity.

We had no customers that accounted for more than 10% of our revenues during the six months ended June 30, 2007. In addition to direct sales to customers, some of our end customers purchase products indirectly from us through distributors and contract manufacturers. An end customer purchasing through a contract manufacturer typically instructs such contract manufacturer to obtain our products and incorporate such products with other components for sale by such contract manufacturer to the end customer. Although we actually sell the products to, and are paid by, the distributors and contract manufacturers, we refer to such end customer as our customer. Two of our distributors, Edom Technology and Avnet, represented 41% and 11% of our revenues during the six months ended June 30, 2007, respectively. There were no other distributors or contract manufacturers that accounted for more than 10% of our revenues during the six months ended June 30, 2007.

The percentage of our revenues derived from customers located outside of the United States was 84% in fiscal 2006, which reflects our product and customer diversification and market penetration for our products, as many of our customers manufacture and design their products in Asia. All of our revenues to date have been denominated in U.S. dollars. We believe that a majority of our revenues will continue to be derived from customers outside of the United States.

The sales cycle for the test and evaluation of our ICs can range from one month to 12 months or more. An additional three to six months or more are usually required before a customer ships a significant volume of devices that incorporate our ICs. Due to this lengthy sales cycle, we typically experience a significant delay between incurring expenses for research and development and selling, general and administrative efforts, and the generation of corresponding sales. Consequently, if sales in any quarter do not occur when expected, expenses and inventory levels could be disproportionately high, and our operating results for that quarter and, potentially, future quarters would be adversely affected. Moreover, the amount of time between initial research and development and commercialization of a product, if ever, can be substantially longer than the sales cycle for the product. Accordingly, if we incur substantial research and development costs without developing a commercially successful product, our operating results, as well as our growth prospects, could be adversely affected.

Because many of our ICs are designed for use in consumer products such as personal computers, personal video recorders, set-top boxes and mobile handsets, we expect that the demand for our products will be typically subject to some degree of seasonal demand. However, rapid changes in our markets and across our product areas make it difficult for us to accurately estimate the impact of seasonal factors on our business.

#### **Discontinued Operation**

On February 8, 2007, we entered into a Sale and Purchase Agreement pursuant to which we sold our Aero transceiver, AeroFONE single-chip phone and power amplifier product lines to NXP in exchange for \$285 million in cash, with additional earn-out potential of up to an aggregate of \$65 million over the next three years. The sale was completed on March 23, 2007. The results of operations of the sold product lines have been presented as discontinued operations.

## Results of Operations

The following describes the line items set forth in our condensed consolidated statements of income:

**Revenues.** Revenues are generated almost exclusively by sales of our ICs. We recognize revenue on sales when all of the following criteria are met: 1) there is persuasive evidence that an arrangement exists, 2) delivery of goods has occurred, 3) the sales price is fixed or determinable, and 4) collectibility is reasonably assured. Generally, we recognize revenue from product sales direct to customers and contract manufacturers upon shipment. Certain of our sales are made to distributors under agreements allowing certain rights of return and price protection on products unsold by distributors. Accordingly, we defer the revenue and cost of revenue on such sales until the distributors sell the product to the end customer. Our products typically carry a one-year replacement warranty. Replacements have been insignificant to date. Our revenues are subject to variation from period to period due to the volume of shipments made within a period and the prices we charge for our products. The vast majority of our revenues were negotiated at prices that reflect a discount from the list prices for our products. These discounts are made for a variety of reasons, including: 1) to establish a relationship with a new customer, 2) as an incentive for customers to purchase products in larger volumes, 3) to provide profit margin to our distributors who resell our products or 4) in response to competition. In addition, as a product matures, we expect that the average selling price for such product will decline due to the greater availability of competing products. Our ability to increase revenues in the future is dependent on increased demand for our established products and our ability to ship larger volumes of those products in response to such demand, as well as our ability to develop or acquire new products and subsequently achieve customer acceptance of newly introduced products.

**Cost of revenues.** Cost of revenues includes the cost of purchasing finished silicon wafers processed by independent foundries; costs associated with assembly, test and shipping of those products; costs of personnel and equipment associated with manufacturing support, logistics and quality assurance; costs of software royalties and amortization of purchased software, other intellectual property license costs, and certain acquired intangible assets; an allocated portion of our occupancy costs; allocable depreciation of testing equipment and leasehold improvements; and impairment charges related to certain manufacturing equipment held for sale or abandoned. Generally, we depreciate equipment over four years on a straight-line basis and leasehold improvements over the shorter of the estimated useful life or the applicable lease term. Recently introduced products tend to have higher cost of revenues per unit due to initially low production volumes required by our customers and higher costs associated with new package variations. As production volumes for a product increase, unit production costs tend to decrease as our yields improve and our semiconductor fabricators, assemblers and test suppliers achieve greater economies of scale for that product. Additionally, the cost of wafer procurement and assembly and test services, which are significant components of cost of goods sold, vary cyclically with overall demand for semiconductors and our suppliers' available capacity of such products and services.

**Research and development.** Research and development expense consists primarily of personnel-related expenses, including stock compensation, new product mask, wafer, packaging and test costs, external consulting and services costs, amortization of purchased software, equipment tooling, equipment depreciation, amortization of acquired intangible assets, acquired research and development resulting from acquisitions, as well as an allocated portion of our occupancy costs for such operations. We generally depreciate our research and development equipment over four years and amortize our purchased software from computer-aided design tool vendors over the shorter of the estimated useful life or the license term. Research and development activities include the design of new products and software, refinement of existing products and design of test methodologies to ensure compliance with required specifications.

**Selling, general and administrative.** Selling, general and administrative expense consists primarily of personnel-related expenses, including stock compensation, related allocable portion of our occupancy costs, sales commissions to independent sales representatives, applications engineering support, professional fees, directors' and officers' liability insurance, patent litigation legal fees, reserves for bad debt and promotional and marketing expenses.

**In-process research and development.** In-process research and development represents acquired technology resulting from business combinations that has not achieved technological feasibility and has no alternative future use. These costs are expensed on the date of acquisition.

**Interest income.** Interest income reflects interest earned on average cash, cash equivalents and investment balances.

**Interest expense.** Interest expense consists of interest on our short and long-term obligations.

**Other income (expense), net.** Other income (expense), net reflects foreign currency remeasurement adjustments and gains on the disposal of fixed assets.

**Provision for Income Taxes.** We accrue a provision for domestic and foreign income tax at the applicable statutory rates adjusted for non-deductible expenses (including stock compensation), research and development tax credits and interest income from tax-exempt short-term investments.

The following table sets forth our condensed consolidated statements of income data as a percentage of revenues for the periods indicated:

	Three Months Ended		Six Months Ended	
	June 30,	July 1,	June 30,	July 1,
	2007	2006	2007	2006
Revenues	100.0	100.0	100.0	100.0
Cost of revenues	40.0	33.1	39.3	32.4
Gross profit	60.0	66.9	60.7	67.6
Operating expenses:				
Research and development	29.3	30.6	31.4	31.1
Selling, general and administrative	28.2	30.9	30.5	31.0
In-process research and development		3.5		1.8
Operating expenses	57.5	65.0	61.9	63.9
Operating income (loss)	2.5	1.9	(1.2)	3.7
Other income (expense):				
Interest income	9.4	5.0	7.3	4.9
Interest expense	(0.2)	(0.3)	(0.2)	(0.3)
Other income (expense), net	(0.1)	0.1	(0.1)	0.2
Income from continuing operations before income taxes	11.6	6.7	5.8	8.5
Provision for income taxes	2.5	2.6	1.6	2.6
Income from continuing operations	9.1	4.1	4.2	5.9
Income from discontinued operations, net of income taxes	0.8	9.6	105.0	9.2
Net income	9.9	13.7	109.2	15.1

**Revenues**

(in millions)	Three Months Ended				Six Months Ended				
	June 30, 2007	July 1, 2006	Change	% Change	June 30, 2007	July 1, 2006	Change	% Change	
Revenues	\$ 75.6	\$ 73.9	\$ 1.7	2.2	% \$ 149.4	\$ 140.6	\$ 8.8	6.3	%

The growth in the sales of our products for the recent three and six month periods was primarily driven by increased revenues from our FM broadcast radio tuners and microcontroller products. Such growth was offset in part by a decline in revenues from our modem and ProSLIC products. Unit volumes of our products increased compared to the three and six months ended July 1, 2006 by 18.3% and 22.5%, respectively. Average selling prices decreased during the same periods by 13.7% and 13.4%, respectively. As our products become more mature, we expect to experience decreases in average selling prices. We anticipate that newly announced higher priced, next generation products and product extensions will offset these decreases to some degree.

**Gross Profit**

(in millions)	Three Months Ended				Six Months Ended				
	June 30, 2007	July 1, 2006	Change	% Change	June 30, 2007	July 1, 2006	Change	% Change	
Gross profit	\$ 45.4	\$ 49.5	\$ (4.1 )	(8.3 )	% \$ 90.7	\$ 95.0	\$ (4.3 )	(4.5 )	%
Percent of revenue	60.0	% 66.9	%		60.7	% 67.6	%		

The decrease in gross profit as a percent of revenue for the recent three and six month periods was primarily due to changes in product mix, certain write-downs of inventory and increases in fixed manufacturing spending. We may experience declines in the average selling prices of certain of our products. This downward pressure on gross profit as a percentage of revenues may be offset to the extent we are able to: 1) introduce higher margin new products and gain market share with our ICs; or 2) achieve lower production costs from our wafer foundries and third-party assembly and test subcontractors.

**Research and Development**

(in millions)	Three Months Ended				Six Months Ended				
	June 30, 2007	July 1, 2006	Change	% Change	June 30, 2007	July 1, 2006	Change	% Change	
Research and development	\$ 22.1	\$ 22.6	\$ (0.5 )	(2.1 )	% \$ 47.0	\$ 43.7	\$ 3.3	7.5	%
Percent of revenue	29.3	% 30.6	%		31.4	% 31.1	%		

The decrease in research and development expense for the recent three month period was principally due to (a) \$1.4 million of reduced occupancy and IT support costs, which were billed to NXP in connection with our transition services agreement, (b) decreased depreciation of \$0.3 million, and (c) decreased product introduction costs of \$0.5 million, offset in part by an increase of \$1.7 million for stock compensation and other personnel-related expenses. The increase in research and development expense for the recent six month period was principally due to an increase of \$7.0 million for stock compensation and other personnel-related expenses, offset in part by (a) \$1.4 million of reduced occupancy and IT support costs, which were billed to NXP in connection with our transition services agreement, (b) decreased depreciation of \$1.5 million, and (c) decreased product introduction costs of \$1.1 million.

Significant recent development projects include a fully integrated AM/FM radio receiver, a dual ProSLIC for VoIP equipment, the expansion of our microcontroller portfolio and families of jitter-attenuating clock multipliers, single-chip FM radio transceivers and highly integrated FM transmitters. We expect that research and development expense will increase moderately in absolute dollars and may fluctuate as a percentage of revenues due to changes in sales and the timing of certain expensive items related to new product development initiatives, such as engineering mask and wafer costs.

### Selling, General and Administrative

(in millions)	Three Months Ended				Six Months Ended			
	June 30, 2007	July 1, 2006	Change	% Change	June 30, 2007	July 1, 2006	Change	% Change
Selling, general and administrative	\$ 21.3	\$ 22.8	\$ (1.5 )	(6.7 )%	\$ 45.6	\$ 43.6	\$ 2.0	4.6 %
Percent of revenue	28.2	% 30.9	%		30.5	% 31.0	%	

The decrease in selling, general and administrative expense for the recent three month period was principally due to a decrease of \$1.0 million for stock compensation and other personnel-related expenses, offset in part by an increase of \$0.7 million for depreciation. Selling, general and administrative expense for the recent six month period increased primarily due to increases of \$1.0 million in stock compensation and other personnel-related expenses, \$1.0 million in legal fees related to litigation and \$0.8 million for depreciation. Selling, general and administrative expense also reflects a decrease of \$0.5 million for the recent three and six month periods due to reduced occupancy costs, which were billed to NXP in connection with our TSA. We expect that selling, general and administrative expense will remain relatively stable in absolute dollars in future periods.

### In-process research and development

In-process research and development (IPR&D) related to the acquisition of Silembia was \$2.6 million for the three and six months ended July 1, 2006. There was no IPR&D for the three and six months ended June 30, 2007.

### Interest Income

(in millions)	Three Months Ended			Six Months Ended		
	June 30, 2007	July 1, 2006	Change	June 30, 2007	July 1, 2006	Change
Interest income	\$ 7.0	\$ 3.6	\$ 3.4	\$ 10.9	\$ 6.8	\$ 4.1

The increases in interest income for the recent three and six month periods were primarily due to greater cash and short-term investments balances, and to a lesser extent, an increase in interest rates of the underlying instruments.

### Interest Expense

Interest expense was \$0.2 million and \$0.4 million for the three and six months ended June 30, 2007 and July 1, 2006, respectively.

### Other Income (Expense), Net

Other income (expense), for the three and six months ended June 30, 2007 was \$(0.1) million and \$(0.2) million, respectively, as compared to \$45 thousand and \$0.3 million for the three and six months ended July 1, 2006, respectively.



**Provision for Income Taxes**

(in millions)	Three Months Ended			Six Months Ended		
	June 30, 2007	July 1, 2006	Change	June 30, 2007	July 1, 2006	Change
Provision for income taxes	\$ 1.9	\$ 1.9	\$ 0	\$ 2.4	\$ 3.7	\$ (1.3 )
Effective tax rate	21.2	% 38.6	%	27.8	% 31.0	%

The effective tax rate for the three months ended June 30, 2007 was lower than the three months ended July 1, 2006 primarily due to the non-deductibility of the write-off of in-process research and development expense in 2006. This impact was partially offset by a decrease in the favorable impact of tax exempt interest income in 2007.

The effective tax rate for the six months ended June 30, 2007 was also lower than the six months ended July 1, 2006 primarily due to the non-deductibility of the write-off of in-process research and development expense in 2006. This impact was partially offset by a decrease in the tax benefit realized on income earned by foreign operations as well as a decrease in the favorable impact of tax exempt interest income in 2007.

The effective tax rates for each of the periods presented differ from the federal statutory rate of 35% due to the amount of income earned in foreign jurisdictions where the tax rate may be lower than the federal statutory rate, tax exempt interest income, non-deductible stock compensation expense and other permanent items.

**Income from discontinued operations, net of income taxes**

(in millions)	Three Months Ended			Six Months Ended		
	June 30, 2007	July 1, 2006	Change	June 30, 2007	July 1, 2006	Change
Income from discontinued operations, net of income taxes	\$ 0.6	\$ 7.1	\$ (6.5 )	\$ 156.9	\$ 13.0	\$ 143.9

Revenues from our discontinued operations for the three and six months ended June 30, 2007 were \$5.2 million and \$43.2 million, respectively, as compared to \$49.6 million and \$97.5 million for the three and six months ended July 1, 2006, respectively. Income from our discontinued operations for the six months ended June 30, 2007 included a gain on sale of \$154.9 million, net of related income taxes. See Note 2 for additional information.

**Business Outlook**

We expect revenues in the third quarter of fiscal 2007 to be in the range of \$81 to \$84 million. Furthermore, we expect our diluted net income per share to be in the range of \$0.16 to \$0.18.

**Liquidity and Capital Resources**

Our principal sources of liquidity as of June 30, 2007 consisted of \$644.0 million in cash, cash equivalents and short-term investments. Our short-term investments consist primarily of municipal bonds.

Net cash used in operating activities was \$16.6 million during the six months ended June 30, 2007, compared to net cash provided of \$31.6 million during the six months ended July 1, 2006. Operating cash flows during the six months ended June 30, 2007 reflect our net income of \$163.1 million, adjustments of \$127.8 million for income from discontinued operations, depreciation, amortization and stock compensation, and a net decrease in the change of our operating assets and liabilities of \$51.9 million (including a \$40.0 million estimated tax payment due to the gain on the sale of our Aero product lines).

Net cash provided by investing activities was \$104.8 million during the six months ended June 30, 2007, compared to net cash provided of \$11.0 million during the six months ended July 1, 2006. The increase was principally due to cash proceeds of \$270.7 million from the sale of our Aero product lines (which excludes \$14.3 million held in escrow) and a decrease of \$16.0 million used for business acquisitions, offset by an increase of \$199.3 million in net purchases of short-term investments.

We anticipate capital expenditures of approximately \$10 to \$15 million for fiscal 2007. Additionally, as part of our growth strategy, we expect to evaluate opportunities to invest in or acquire other businesses, intellectual property or technologies that would complement or expand our current offerings, expand the breadth of our markets or enhance our technical capabilities.

Net cash used in financing activities was \$10.5 million during the six months ended June 30, 2007, compared to net cash provided of \$33.4 million during the six months ended July 1, 2006. The decrease was principally due to a decrease of \$21.6 million of proceeds from the exercise of employee stock options and payments of \$18.5 million for repurchases of our common stock in the recent six month period.

Net cash provided by discontinued operations was \$16.1 million during the six months ended June 30, 2007, compared to net cash provided of \$2.7 million during the six months ended July 1, 2006.

Our future capital requirements will depend on many factors, including the rate of sales growth, market acceptance of our products, the timing and extent of research and development projects, potential acquisitions of companies or technologies and the expansion of our sales and marketing activities. We believe our existing cash and short-term investment balances are sufficient to meet our capital requirements through at least the next 12 months, although we could be required, or could elect, to seek additional funding prior to that time. We may enter into acquisitions or strategic arrangements in the future which also could require us to seek additional equity or debt financing.

#### **Critical Accounting Policies and Estimates**

The preparation of financial statements and accompanying notes in conformity with U.S. generally accepted accounting principles requires that we make estimates and assumptions that affect the amounts reported. Changes in facts and circumstances could have a significant impact on the resulting estimated amounts included in the financial statements. We believe the following critical accounting policies affect our more complex judgments and estimates. We also have other policies that we consider to be key accounting policies, such as our policies for revenue recognition, including the deferral of revenues and cost of revenues on sales to distributors; however, these policies do not meet the definition of critical accounting estimates because they do not generally require us to make estimates or judgments that are difficult or subjective.

*Allowance for doubtful accounts* We evaluate the collectibility of our accounts receivable based on a combination of 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 to reduce the net receivable to the amount we reasonably believe will be collected. For all other customers, we recognize allowances for doubtful accounts based on a variety of factors including the age of the receivable, the current business environment and our historical experience. If the financial condition of our customers were to deteriorate or if economic conditions worsened, additional allowances may be required in the future.

*Inventory valuation* We assess the recoverability of inventories through the application of a set of methods, assumptions and estimates. In determining net realizable value, we write down inventory that may be slow moving or have some form of obsolescence, including inventory that has aged more than nine months. We also adjust the valuation of inventory when its standard cost exceeds the estimated market value. We assess the potential for any unusual customer returns based on known quality or business issues and establish reserves based on the estimated inventory losses for scrap or non-saleable material. Inventory not otherwise identified to be written down is compared to an assessment of our 12-month forecasted demand. The result of this methodology is compared against the product life cycle and competitive situations in the marketplace to determine the appropriateness of the resulting inventory levels. Demand for our products may fluctuate significantly over time, and actual demand and market conditions may be more or less favorable than those that we project. In the event that actual demand is lower or market conditions are worse than originally projected, additional inventory write-downs may be required.

*Stock compensation* Prior to fiscal 2006, we accounted for stock-based compensation plans under the recognition and measurement provisions of Accounting Principles Board (APB) Opinion No. 25. Effective January 1, 2006, we adopted the provisions of SFAS 123R using the modified-prospective-transition method. SFAS 123R requires companies to recognize the fair-value of stock-based compensation transactions in the statement of income. The fair value of our stock-based awards is estimated at the date of grant using the Black-Scholes option pricing model. The Black-Scholes valuation calculation requires us to estimate key assumptions such as future stock price volatility, expected terms, risk-free rates and dividend yield. Expected stock price volatility is based on implied volatility from traded options on our stock in the marketplace and historical volatility of our stock. The expected term of options granted is derived from an analysis of historical exercises and remaining contractual life of stock options, and represents the period of time that options granted are expected to be outstanding. The risk-free rate is based on the U.S. Treasury yield curve in effect at the time of grant. We have never paid cash dividends, and do not currently intend to pay cash dividends, and thus have assumed a 0% dividend yield. In addition, we are required to estimate the expected forfeiture rate of our stock grants and only recognize the expense for those shares expected to vest. If our actual experience differs significantly from the assumptions used to compute our stock-based compensation cost, or if different assumptions had been used, we may have recorded too much or too little stock-based compensation cost. We had approximately \$92.7 million of total unrecognized compensation costs related to stock options and RSUs at June 30, 2007 that are expected to be recognized over a weighted-average period of 2.2 years. See Note 5 for a further discussion on stock-based compensation.

*Impairment of goodwill and other long-lived assets* We review long-lived assets which are held and used, including fixed assets and purchased intangible assets, for impairment whenever changes in circumstances indicate that the carrying amount of the assets may not be recoverable. Such evaluations compare the carrying amount of an asset to future undiscounted net cash flows expected to be generated by the asset over its expected useful life and are significantly impacted by estimates of future prices and volumes for our products, capital needs, economic trends and other factors which are inherently difficult to forecast. If the asset is considered to be impaired, we record an impairment charge equal to the amount by which the carrying value of the asset exceeds its fair value determined by either a quoted market price, if any, or a value determined by utilizing a discounted cash flow technique. Occasionally, we may hold certain assets for sale. In those cases, the assets are reclassified on our balance sheet from long-term to current, and the carrying value of such assets are reviewed and adjusted each period thereafter to the fair value less expected cost to sell.

We test our goodwill for impairment annually as of the first day of our fourth fiscal quarter and in interim periods if certain events occur indicating that the carrying value of goodwill may be impaired. The goodwill impairment test is a two-step process. The first step of the impairment analysis compares our fair value to our net book value. In determining fair value, the accounting guidance allows for the use of several valuation methodologies, although it states quoted market prices are the best evidence of fair value. If the fair value is less than the net book value, the second step of the analysis compares the implied fair value of our goodwill to its carrying amount. If the carrying amount of goodwill exceeds its implied fair value, we recognize an impairment loss equal to that excess amount.

*Income taxes* We are required to estimate income taxes in each of the jurisdictions in which we operate. This process involves estimating the actual current tax liability together with assessing temporary differences in recognition of income (loss) for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are included in our consolidated balance sheet. We then assess the likelihood that the deferred tax assets will be recovered from future taxable income and, to the extent we believe that recovery is not likely, we establish a valuation allowance against the deferred tax asset. Further, we operate within multiple taxing jurisdictions and are subject to audit in these jurisdictions. These audits can involve complex issues which may require an extended period of time to resolve and could result in additional assessments of income tax. We believe adequate provisions for income taxes have been made for all periods.

#### **Recent Accounting Pronouncements**

In February 2007, the FASB issued SFAS 159, *The Fair Value Option for Financial Assets and Financial Liabilities* Including an amendment of FASB Statement No. 115. SFAS 159 expands the use of fair value accounting to many financial instruments and certain other items. The fair value option is irrevocable and generally made on an instrument-by-instrument basis, even if a company has similar instruments that it elects not to measure based on fair value. SFAS 159 is effective for fiscal years beginning after November 15, 2007. We are currently evaluating the effect that the adoption of SFAS 159 will have on our financial position and results of operations.

In September 2006, the FASB issued SFAS 157, *Fair Value Measurements*. SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP) and expands disclosures about fair value measurements. SFAS 157 is effective for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. We are currently evaluating the effect that the adoption of SFAS 157 will have on our financial position and results of operations.

#### **Qualitative and Quantitative Disclosures about Market Risk**

Our financial instruments include cash, cash equivalents and short-term investments. Our main investment objectives are the preservation of investment capital and the maximization of after-tax returns on our investment portfolio. Our interest income is sensitive to changes in the general level of U.S. interest rates. Based on our cash, cash equivalents and short-term investments holdings as of June 30, 2007, an immediate 100 basis point decline in the yield for such instruments would decrease our annual interest income by approximately \$6.4 million. We believe that our investment policy is conservative, both in the duration of our investments and the credit quality of the investments we hold.

#### **Available Information**

Our internet website address is <http://www.silabs.com>. Our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 are available through the investor relations page of our internet website free of charge as soon as reasonably practicable after we electronically file such material with, or furnish it to, the Securities and Exchange Commission (SEC). Our internet website and the information contained therein or connected thereto are not intended to be incorporated into this Quarterly Report on Form 10-Q.

#### **Item 3. Quantitative and Qualitative Disclosures About Market Risk**

Information related to quantitative and qualitative disclosures regarding market risk is set forth in Management's Discussion and Analysis of Financial Condition and Results of Operations under Item 2 above. Such information is incorporated by reference herein.

#### **Item 4. Controls and Procedures**

We have performed an evaluation under the supervision and with the participation of our management, including our Chief Executive Officer (CEO) and Chief Financial Officer (CFO), of the effectiveness of our disclosure controls and procedures, as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934 (the Exchange Act). Based on that evaluation, our management, including our CEO and CFO, concluded that our disclosure controls and procedures were effective as of June 30, 2007 to provide reasonable assurance that information required to be disclosed by us in the reports filed or submitted by us under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms.

In April 2007, we implemented a global enterprise resource planning (ERP) system to help us improve our planning and management processes. The migration of certain legacy systems to the new ERP system required us to make significant changes to our internal controls over financial reporting. We believe we have taken the necessary steps to monitor and maintain appropriate internal controls during this implementation. There were no other changes in our internal controls during the fiscal quarter ended June 30, 2007 that materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

#### **Part II. Other Information**

##### **Item 1. Legal Proceedings**

###### *Securities Litigation*

On December 6, 2001, a class action complaint for violations of U.S. federal securities laws was filed in the United States District Court for the Southern District of New York against us, four of our officers individually and the three investment banking firms who served as representatives of the underwriters in connection with our initial public offering of common stock. The Consolidated Amended Complaint alleges that the registration statement and prospectus for our initial public offering did not disclose that (1) the underwriters solicited and received additional, excessive and undisclosed commissions from certain investors, and (2) the underwriters had agreed to allocate shares of the offering in exchange for a commitment from the customers to purchase additional shares in the aftermarket at pre-determined higher prices. The action seeks damages in an unspecified amount and is being coordinated with approximately 300 other nearly identical actions filed against other companies. A court order dated October 9, 2002 dismissed without prejudice our four officers who had been named individually. On February 19, 2003, the Court denied the motion to dismiss the complaint against us. On October 13, 2004, the Court certified a class in six of the approximately 300 other nearly identical actions (the "focus cases") and noted that the decision was intended to provide strong guidance to all parties regarding class certification in the remaining cases. The Underwriter Defendants appealed the decision and a panel of the Second Circuit vacated the District Court's decision granting class certification in those six cases on December 5, 2006. Plaintiffs filed a petition for rehearing on January 5, 2007. On April 6, 2007, the Second Circuit denied the petition for rehearing, but noted that plaintiffs could ask the District Court to certify a more narrow class than the one that was rejected.

Prior to the Second Circuit's decision, we had approved a settlement agreement and related agreements which set forth the terms of a settlement between us, the purported plaintiff class and the vast majority of the other approximately 300 issuer defendants. These agreements were submitted to the Court for approval. In light of the Second Circuit opinion, the parties agreed that the settlement cannot be approved because the defined settlement class, like the litigation class, cannot be certified. On June 22, 2007, the plaintiffs and the issuers agreed to a stipulation terminating the proposed settlement, subject to court approval. The Court approved the stipulation terminating the settlement on June 25, 2007. We cannot predict whether we will be able to renegotiate a settlement that complies with the Second Circuit's mandate. Due to the inherent uncertainties of litigation, we cannot accurately predict the ultimate outcome of the matter.

We are unable to estimate or predict the potential damages that might be awarded as a result of this litigation, whether such damages would be greater than our insurance coverage, or whether the outcome would have a material impact on our results of operations or financial position.

*Patent and Copyright Infringement Litigation*

On December 14, 2006, Analog Devices, Inc. (Analog Devices), a Massachusetts corporation, filed a lawsuit against us, in the United States District Court in the District of Massachusetts, alleging infringement of United States Patents 7,075,329, 6,262,600, 6,525,566, 6,903,578 and 6,873,065, and copyright infringement of certain Analog Devices datasheets. On January 31, 2007, we filed our answer to Analog Devices complaint, in which we denied infringement and asserted that Analog Devices' patents are invalid. We also filed counterclaims in which we alleged that Analog Devices has engaged in unfair competition under both state and federal law. The Court has scheduled a trial date in May 2008. The lawsuit relates to our Si843x and Si844x family of digital isolator products and alleges that the infringement was and continues to be willful. At this time, we cannot estimate the outcome of this matter or resulting financial impact to us, if any.

**Other**

We are involved in various other legal proceedings that have arisen in the normal course of business. While the ultimate results of these matters cannot be predicted with certainty, we do not expect them to have a material adverse effect on the consolidated financial position or results of operations.

**Item 1A. Risk Factors**

**Risks Related to our Business**

**We may not be able to maintain our historical growth and may experience significant period-to-period fluctuations in our revenues and operating results, which may result in volatility in our stock price**

Although we have generally experienced revenue growth in our history, we may not be able to sustain this growth. We may also experience significant period-to-period fluctuations in our revenues and operating results in the future due to a number of factors, and any such variations may cause our stock price to fluctuate. It is likely that in some future period our revenues or operating results will be below the expectations of public market analysts or investors. If this occurs, our stock price may drop, perhaps significantly.

A number of factors, in addition to those cited in other risk factors applicable to our business, may contribute to fluctuations in our revenues and operating results, including:

- The timing and volume of orders received from our customers;
- The timeliness of our new product introductions and the rate at which our new products may cannibalize our older products;
- The rate of acceptance of our products by our customers, including the acceptance of new products we may develop for integration in the products manufactured by such customers, which we refer to as "design wins";
- The time lag and realization rate between "design wins" and production orders;
- The demand for, and life cycles of, the products incorporating our ICs;
- The rate of adoption of mixed-signal ICs in the markets we target;
- Deferrals or reductions of customer orders in anticipation of new products or product enhancements from us or our competitors or other providers of ICs;



- Changes in product mix;
- The average selling prices for our products could drop suddenly due to competitive offerings or competitive predatory pricing, especially with respect to our mobile handset and modem products;
- The average selling prices for our products generally decline over time;
- Changes in market standards;
- Impairment charges related to inventory, equipment or other long-lived assets;
- The software used in our products and provided by third-party software providers must meet the needs of our customers;
- Significant legal costs to defend our intellectual property rights or respond to claims against us; and
- The rate at which new markets emerge for products we are currently developing or for which our design expertise can be utilized to develop products for these new markets.

The markets for mobile handsets, personal computers, satellite set-top boxes and VoIP applications are characterized by rapid fluctuations in demand and seasonality that result in corresponding fluctuations in the demand for our products that are incorporated in such devices. Additionally, the rate of technology acceptance by our customers results in fluctuating demand for our products as customers are reluctant to incorporate a new IC into their products until the new IC has achieved market acceptance. Once a new IC achieves market acceptance, demand for the new IC can quickly accelerate to a point and then level off such that rapid historical growth in sales of a product should not be viewed as indicative of continued future growth. In addition, demand can quickly decline for a product when a new IC product is introduced and receives market acceptance. Due to the various factors mentioned above, the results of any prior quarterly or annual periods should not be relied upon as an indication of our future operating performance.

**If we are unable to develop or acquire new and enhanced products that achieve market acceptance in a timely manner, our operating results and competitive position could be harmed**

Our future success will depend on our ability to reduce our dependence on a few products by developing or acquiring new ICs and product enhancements that achieve market acceptance in a timely and cost-effective manner. The development of mixed-signal ICs is highly complex, and we have at times experienced delays in completing the development and introduction of new products and product enhancements. Successful product development and market acceptance of our products depend on a number of factors, including:

- Changing requirements of customers;
- Accurate prediction of market and technical requirements;
- Timely completion and introduction of new designs;
- Market trends towards integration of discrete components onto one device;
- Timely qualification and certification of our ICs for use in our customers' products;
- Commercial acceptance and volume production of the products into which our ICs will be incorporated;
- Availability of foundry, assembly and test capacity;





- Achievement of high manufacturing yields;
- Quality, price, performance, power use and size of our products;
- Availability, quality, price and performance of competing products and technologies;
- Our customer service, application support capabilities and responsiveness;
- Successful development of our relationships with existing and potential customers;
- Changes in technology, industry standards or end-user preferences; and
- Cooperation of third-party software providers and our semiconductor vendors to support our chips within a system.

We cannot provide any assurance that products which we recently have developed or may develop in the future will achieve market acceptance. We have introduced to market or are in development of many ICs. If our ICs fail to achieve market acceptance, or if we fail to develop new products on a timely basis that achieve market acceptance, our growth prospects, operating results and competitive position could be adversely affected.

**Our research and development efforts are focused on a limited number of new technologies and products, and any delay in the development, or abandonment, of these technologies or products by industry participants, or their failure to achieve market acceptance, could compromise our competitive position**

Our ICs are used as components in electronic devices in various markets. As a result, we have devoted and expect to continue to devote a large amount of resources to develop products based on new and emerging technologies and standards that will be commercially introduced in the future. Excluding discontinued operations, research and development expense during the six months ended June 30, 2007 was \$47.0 million, or 31.4% of revenues. A number of large companies are actively involved in the development of these new technologies and standards. Should any of these companies delay or abandon their efforts to develop commercially available products based on new technologies and standards, our research and development efforts with respect to these technologies and standards likely would have no appreciable value. In addition, if we do not correctly anticipate new technologies and standards, or if the products that we develop based on these new technologies and standards fail to achieve market acceptance, our competitors may be better able to address market demand than we would. Furthermore, if markets for these new technologies and standards develop later than we anticipate, or do not develop at all, demand for our products that are currently in development would suffer, resulting in lower sales of these products than we currently anticipate.

**We depend on a limited number of customers for a substantial portion of our revenues, and the loss of, or a significant reduction in orders from, any key customer could significantly reduce our revenues**

The loss of any of our key customers, or a significant reduction in sales to any one of them, would significantly reduce our revenues and adversely affect our business. During the six months ended June 30, 2007, our ten largest customers accounted for 35% of our revenues from continuing operations. Some of the markets for our products are dominated by a small number of potential customers. Therefore, our operating results in the foreseeable future will continue to depend on our ability to sell to these dominant customers, as well as the ability of these customers to sell products that incorporate our IC products. In the future, these customers may decide not to purchase our ICs at all, purchase fewer ICs than they did in the past or alter their purchasing patterns, particularly because:

- We do not have material long-term purchase contracts with our customers;

- Substantially all of our sales to date have been made on a purchase order basis, which permits our customers to cancel, change or delay product purchase commitments with little or no notice to us and without penalty;
- Some of our customers may have efforts underway to actively diversify their vendor base which could reduce purchases of our ICs; and
- Some of our customers have developed or acquired products that compete directly with products these customers purchase from us, which could affect our customers' purchasing decisions in the future.

While we have been a significant supplier of ICs used in many of our customers' products, our customers regularly evaluate alternative sources of supply in order to diversify their supplier base, which increases their negotiating leverage with us and protects their ability to secure these components. We believe that any expansion of our customers' supplier bases could have an adverse effect on the prices we are able to charge and volume of product that we are able to sell to our customers, which would negatively affect our revenues and operating results.

**We have increased our international activities significantly and plan to continue such efforts, which subjects us to additional business risks including increased logistical and financial complexity, political instability and currency fluctuations**

We have established additional international subsidiaries and have opened additional offices in international markets to expand our international activities in Europe and the Pacific Rim region. This has included the establishment of a headquarters in Singapore for non-U.S. operations. The percentage of our revenues from continuing operations derived from customers located outside of the United States was 84% in fiscal 2006. We may not be able to maintain or increase international market demand for our products. Our international operations are subject to a number of risks, including:

- Increased complexity and costs of managing international operations and related tax obligations, including our headquarters for non-U.S. operations in Singapore;
- Protectionist laws and business practices that favor local competition in some countries;
- Difficulties related to the protection of our intellectual property rights in some countries;
- Multiple, conflicting and changing tax laws and regulations that may impact both our international and domestic tax liabilities and result in increased complexity and costs;
- Longer sales cycles;
- Greater difficulty in accounts receivable collection and longer collection periods;
- High levels of distributor inventory subject to price protection and rights of return to us;
- Political and economic instability;
- Greater difficulty in hiring and retaining qualified technical sales and applications engineers and administrative personnel; and
- The need to have business and operations systems that can meet the needs of our international business and operating structure.

To date, all of our sales to international customers and purchases of components from international suppliers have been denominated in U.S. dollars. As a result, an increase in the value of the U.S. dollar relative to foreign currencies could make our products more expensive for our international customers to purchase, thus rendering our products less competitive.



**Failure to manage our distribution channel relationships could impede our future growth**

The future growth of our business will depend in large part on our ability to manage our relationships with current and future distributors and sales representatives, develop additional channels for the distribution and sale of our products and manage these relationships. As we execute our indirect sales strategy, we must manage the potential conflicts that may arise with our direct sales efforts. For example, conflicts with a distributor may arise when a customer begins purchasing directly from us rather than through the distributor. The inability to successfully execute or manage a multi-channel sales strategy could impede our future growth. In addition, relationships with our distributors often involve the use of price protection and inventory return rights. This often requires a significant amount of sales management's time and system resources to manage properly.

**We are subject to increased inventory risks and costs because we build our products based on forecasts provided by customers before receiving purchase orders for the products**

In order to ensure availability of our products for some of our largest customers, we start the manufacturing of our products in advance of receiving purchase orders based on forecasts provided by these customers. However, these forecasts do not represent binding purchase commitments and we do not recognize sales for these products until they are shipped to the customer. As a result, we incur inventory and manufacturing costs in advance of anticipated sales. Because demand for our products may not materialize, manufacturing based on forecasts subjects us to increased risks of high inventory carrying costs, increased obsolescence and increased operating costs. These inventory risks are exacerbated when our customers purchase indirectly through contract manufacturers or hold component inventory levels greater than their consumption rate because this causes us to have less visibility regarding the accumulated levels of inventory for such customers. A resulting write-off of unusable or excess inventories would adversely affect our operating results.

**We are subject to credit risks related to our accounts receivable**

We do not generally obtain letters of credit or other security for payment from customers, distributors or contract manufacturers. Accordingly, we are not protected against accounts receivable default or bankruptcy by these entities. Our ten largest customers or distributors represent a substantial majority of our accounts receivable. If any such customer or distributor were to become insolvent or otherwise not satisfy their obligations to us, we could be materially harmed.

**Our products are complex and may contain errors which could lead to product liability, an increase in our costs and/or a reduction in our revenues**

Our products are complex and may contain errors, particularly when first introduced or as new versions are released. Our new products are increasingly being designed in more complex processes which further increases the risk of errors. We rely primarily on our in-house testing personnel to design test operations and procedures to detect any errors prior to delivery of our products to our customers. Because our products are manufactured by third parties, should problems occur in the operation or performance of our ICs, we may experience delays in meeting key introduction dates or scheduled delivery dates to our customers. These errors also could cause us to incur significant re-engineering costs, divert the attention of our engineering personnel from our product development efforts and cause significant customer relations and business reputation problems. Any defects could require product replacement or recall or we could be obligated to accept product returns. Any of the foregoing could impose substantial costs and harm our business.

Product liability claims may be asserted with respect to our products. Our products are typically sold at prices that are significantly lower than the cost of the end-products into which they are incorporated. A defect or failure in our product could cause failure in our customer's end-product, so we could face claims for damages that are disproportionately higher than the revenues and profits we receive from the products involved. Furthermore, product liability risks are particularly significant with respect to medical and automotive applications because of the risk of serious harm to users of these products. There can be no assurance that any insurance we maintain will sufficiently protect us from any such claims.

**Significant litigation over intellectual property in our industry may cause us to become involved in costly and lengthy litigation which could seriously harm our business**

In recent years, there has been significant litigation in the United States involving patents and other intellectual property rights. From time to time, we receive letters from various industry participants alleging infringement of patents, trademarks or misappropriation of trade secrets or from customers requesting indemnification for claims brought against them by third parties. The exploratory nature of these inquiries has become relatively common in the semiconductor industry. We respond when we deem appropriate and as advised by legal counsel. We have been involved in litigation to protect our intellectual property rights in the past and may become involved in such litigation again in the future. For example, in December 2006, Analog Devices, Inc. filed a lawsuit against us alleging willful infringement of certain intellectual property rights owned by them - see Part II, Item 1. Legal Proceedings. In the future, we may become involved in additional litigation to defend allegations of infringement asserted by others, both directly and indirectly as a result of certain industry-standard indemnities we may offer to our customers. Legal proceedings could subject us to significant liability for damages or invalidate our proprietary rights. Legal proceedings initiated by us to protect our intellectual property rights could also result in counterclaims or countersuits against us. Any litigation, regardless of its outcome, would likely be time-consuming and expensive to resolve and would divert our management's time and attention. Most intellectual property litigation also could force us to take specific actions, including:

- Cease selling products that use the challenged intellectual property;
- Obtain from the owner of the infringed intellectual property a right to a license to sell or use the relevant technology, which license may not be available on reasonable terms, or at all;
- Redesign those products that use infringing intellectual property; or
- Pursue legal remedies with third parties to enforce our indemnification rights, which may not adequately protect our interests.

**Our customers require our products to undergo a lengthy and expensive qualification process without any assurance of product sales**

Prior to purchasing our products, our customers require that our products undergo an extensive qualification process, which involves testing of the products in the customer's system as well as rigorous reliability testing. This qualification process may continue for six months or longer. However, qualification of a product by a customer does not ensure any sales of the product to that customer. Even after successful qualification and sales of a product to a customer, a subsequent revision to the IC or software, changes in the IC's manufacturing process or the selection of a new supplier by us may require a new qualification process, which may result in delays and in us holding excess or obsolete inventory. After our products are qualified, it can take an additional six months or more before the customer commences volume production of components or devices that incorporate our products. Despite these uncertainties, we devote substantial resources, including design, engineering, sales, marketing and management efforts, toward qualifying our products with customers in anticipation of sales. If we are unsuccessful or delayed in qualifying any of our products with a customer, such failure or delay would preclude or delay sales of such product to the customer, which may impede our growth and cause our business to suffer.

**We rely on third parties to manufacture, assemble and test our products and the failure to successfully manage our relationships with our manufacturers and subcontractors would negatively impact our ability to sell our products**

We do not have our own wafer fab manufacturing facilities. Therefore, we rely principally on one third-party vendor, Taiwan Semiconductor Manufacturing Co. (TSMC), to manufacture the ICs we design. We also currently rely on Asian third-party assembly subcontractors, principally Advanced Semiconductor Engineering (ASE), to assemble and package the silicon chips provided by the wafers for use in final products. Additionally, we rely on these offshore subcontractors for a substantial portion of the testing requirements of our products prior to shipping. We expect utilization of third-party subcontractors to continue in the future.

The cyclical nature of the semiconductor industry drives wide fluctuations in available capacity at third-party vendors. On occasion, we have been unable to adequately respond to unexpected increases in customer demand due to capacity constraints and, therefore, were unable to benefit from this incremental demand. We may be unable to obtain adequate foundry, assembly or test capacity from our third-party subcontractors to meet our customers' delivery requirements even if we adequately forecast customer demand.

There are significant risks associated with relying on these third-party foundries and subcontractors, including:

- Failure by us, our customers or their end customers to qualify a selected supplier;
- Potential insolvency of the third-party subcontractors;
- Reduced control over delivery schedules and quality;
- Limited warranties on wafers or products supplied to us;
- Potential increases in prices or payments in advance for capacity;
- Increased need for international-based supply, logistics and financial management;
- Their inability to supply or support new or changing packaging technologies; and
- Low test yields.

We typically do not have long-term supply contracts with our third-party vendors which obligate the vendor to perform services and supply products to us for a specific period, in specific quantities, and at specific prices. Our third-party foundry, assembly and test subcontractors typically do not guarantee that adequate capacity will be available to us within the time required to meet demand for our products. In the event that these vendors fail to meet our demand for whatever reason, we expect that it would take up to twelve months to transition performance of these services to new providers. Such a transition may also require qualification of the new providers by our customers or their end customers.

Since our inception, most of the silicon wafers for the products that we have shipped were manufactured either by TSMC or its affiliates. Our customers typically complete their own qualification process. If we fail to properly balance customer demand across the existing semiconductor fabrication facilities that we utilize or are required by our foundry partners to increase, or otherwise change the number of fab lines that we utilize for our production, we might not be able to fulfill demand for our products and may need to divert our engineering resources away from new product development initiatives to support the fab line transition, which would adversely affect our operating results.

#### **Our products incorporate technology licensed from third parties**

We incorporate technology (including software) licensed from third parties in our products. We could be subjected to claims of infringement regardless of our lack of involvement in the development of the licensed technology. Although a third party licensor is typically obligated to indemnify us if the licensed technology infringes on another party's intellectual property rights, such indemnification is typically limited in amount and may be worthless if the licensor becomes insolvent. See Significant litigation over intellectual property in our industry may cause us to become involved in costly and lengthy litigation which could seriously harm our business. Furthermore, any failure of third party technology to perform properly would adversely affect sales of our products incorporating such technology.

**Our inability to manage growth could materially and adversely affect our business**

Our past growth has placed, and any future growth of our operations will continue to place, a significant strain on our management personnel, systems and resources. We anticipate that we will need to implement a variety of new and upgraded sales, operational and financial enterprise-wide systems, information technology infrastructure, procedures and controls, including the improvement of our accounting and other internal management systems to manage this growth and maintain compliance with regulatory guidelines, including Sarbanes-Oxley Act requirements. In April 2007, we implemented a global enterprise resource planning (ERP) system to help us improve our planning and management processes. We have experienced, and may continue to experience, challenges in implementing the new ERP system and other related systems that could adversely affect our business by disrupting our ability to timely and accurately process and report key components of our financial position, affecting our ability to complete the evaluation of our internal control over financial reporting and attestation activities pursuant to Section 404 of the Sarbanes-Oxley Act of 2002 or disrupting our ability to process certain transactions necessary for our operations. To the extent our business grows, our internal management systems and processes will need to improve to ensure that we remain in compliance. We also expect that we will need to continue to expand, train, manage and motivate our workforce. All of these endeavors will require substantial management effort, and we anticipate that we will require additional management personnel and internal processes to manage these efforts and to plan for the succession from time to time of certain persons who have been key management and technical personnel. If we are unable to effectively manage our expanding global operations, including our international headquarters in Singapore, our business could be materially and adversely affected.

**We are subject to risks relating to product concentration and lack of revenue diversification**

We derive a substantial portion of our revenues from a limited number of products, and we expect these products to continue to account for a large percentage of our revenues in the near term. Continued market acceptance of these products, is therefore, critical to our future success. In addition, substantially all of our products that we have sold include technology related to one or more of our issued U.S. patents. If these patents are found to be invalid or unenforceable, our competitors could introduce competitive products that could reduce both the volume and price per unit of our products. Our business, operating results, financial condition and cash flows could therefore be adversely affected by:

- A decline in demand for any of our more significant products, including our modem products, FM tuners or ProSLIC;
- Failure of our products to achieve continued market acceptance;
- An improved version of our products being offered by a competitor;
- Technological standard or change that we are unable to address with our products;
- A failure to release new products or enhanced versions of our existing products on a timely basis; and
- The failure of our new products to achieve market acceptance.



**We depend on our key personnel to manage our business effectively in a rapidly changing market, and if we are unable to retain our current personnel and hire additional personnel, our ability to develop and successfully market our products could be harmed**

We believe our future success will depend in large part upon our ability to attract and retain highly skilled managerial, engineering, sales and marketing personnel. We believe that our future success will be dependent on retaining the services of our key personnel, developing their successors and certain internal processes to reduce our reliance on specific individuals, and on properly managing the transition of key roles when they occur. There is currently a shortage of qualified personnel with significant experience in the design, development, manufacturing, marketing and sales of analog and mixed-signal ICs. In particular, there is a shortage of engineers who are familiar with the intricacies of the design and manufacturability of analog elements, and competition for such personnel is intense. Our key technical personnel represent a significant asset and serve as the primary source for our technological and product innovations. We may not be successful in attracting and retaining sufficient numbers of technical personnel to support our anticipated growth. The loss of any of our key employees or the inability to attract or retain qualified personnel both in the United States and internationally, including engineers, sales, applications and marketing personnel, could delay the development and introduction of, and negatively impact our ability to sell, our products.

**Any acquisitions we make could disrupt our business and harm our financial condition**

As part of our growth and product diversification strategy, we continue to evaluate opportunities to acquire other businesses, intellectual property or technologies that would complement our current offerings, expand the breadth of our markets or enhance our technical capabilities. The acquisitions that we have made and may make in the future entail a number of risks that could materially and adversely affect our business and operating results, including:

- Problems integrating the acquired operations, technologies or products with our existing business and products;
- Diversion of management's time and attention from our core business;
- Need for financial resources above our planned investment levels;
- Difficulties in retaining business relationships with suppliers and customers of the acquired company;
- Risks associated with entering markets in which we lack prior experience;
- Risks associated with the transfer of licenses of intellectual property;
- Tax issues associated with acquisitions;
- Acquisition-related disputes, including disputes over earn-outs and escrows;
- Potential loss of key employees of the acquired company; and
- Potential impairment of related goodwill and intangible assets.

Future acquisitions also could cause us to incur debt or contingent liabilities or cause us to issue equity securities that could negatively impact the ownership percentages of existing shareholders.

**Any dispositions we make could harm our financial condition**

In connection with our sale of the Aero product lines, we incurred various risks. This disposition and any disposition that we may make in the future entail a number of risks that could materially and adversely affect our business and operating results, including:

- Diversion of management's time and attention from our core business;
- Difficulties separating the divested business;
- Risks to relations with customers who previously purchased products from our disposed product lines;
- Reduced leverage with suppliers due to reduced aggregate volume;
- Risks related to employee relations;
- Risks associated with the transfer and licensing of intellectual property;
- Security risks and other liabilities related to the transition services provided in connection with the disposition;
- Tax issues associated with dispositions; and
- Disposition-related disputes, including disputes over earn-outs and escrows.

**Our stock price may be volatile**

The market price of our common stock has been volatile in the past and may be volatile in the future. The market price of our common stock may be significantly affected by the following factors:

- Actual or anticipated fluctuations in our operating results;
- Changes in financial estimates by securities analysts or our failure to perform in line with such estimates;
- Changes in market valuations of other technology companies, particularly semiconductor companies;
- Announcements by us or our competitors of significant technical innovations, acquisitions, strategic partnerships, joint ventures or capital commitments;
- Introduction of technologies or product enhancements that reduce the need for our products;
- The loss of, or decrease in sales to, one or more key customers;
- A large sale of stock by a significant shareholder;
- Dilution from the issuance of our stock in connection with acquisitions;
- The addition or removal of our stock to or from a stock index fund;
- Departures of key personnel; and
- The required expensing of stock options.



The stock market has experienced extreme volatility that often has been unrelated to the performance of particular companies. These market fluctuations may cause our stock price to fall regardless of our performance.

**Most of our current manufacturers, assemblers, test service providers, distributors and customers are concentrated in the same geographic region, which increases the risk that a natural disaster, epidemic, labor strike, war or political unrest could disrupt our operations or sales**

Most of TSMC's foundries and several of our assembly and test subcontractors' sites are located in Taiwan and our other assembly and test subcontractors are located in the Pacific Rim region. In addition, many of our customers are located in the Pacific Rim region. The risk of earthquakes in Taiwan and the Pacific Rim region is significant due to the proximity of major earthquake fault lines in the area. We are not currently covered by insurance against business disruption caused by earthquakes as such insurance is not currently available on terms that we believe are commercially reasonable. Earthquakes, fire, flooding, lack of water or other natural disasters, an epidemic, political unrest, war, labor strikes or work stoppages in countries where our semiconductor manufacturers, assemblers and test subcontractors are located, likely would result in the disruption of our foundry, assembly or test capacity. There can be no assurance that such alternate capacity could be obtained on favorable terms, if at all.

A natural disaster, epidemic, labor strike, war or political unrest where our customers' facilities are located would likely reduce our sales to such customers. North Korea's geopolitical maneuverings have created unrest. Such unrest could create economic uncertainty or instability, could escalate to war or otherwise adversely affect South Korea and our South Korean customers and reduce our sales to such customers, which would materially and adversely affect our operating results. In addition, a significant portion of the assembly and testing of our products occurs in South Korea. Any disruption resulting from these events could also cause significant delays in shipments of our products until we are able to shift our manufacturing, assembling or testing from the affected subcontractor to another third-party vendor.

**We may be unable to protect our intellectual property, which would negatively affect our ability to compete**

Our products rely on our proprietary technology, and we expect that future technological advances made by us will be critical to sustain market acceptance of our products. Therefore, we believe that the protection of our intellectual property rights is and will continue to be important to the success of our business. We rely on a combination of patent, copyright, trademark and trade secret laws and restrictions on disclosure to protect our intellectual property rights. We also enter into confidentiality or license agreements with our employees, consultants, intellectual property providers and business partners, and control access to and distribution of our documentation and other proprietary information. Despite these efforts, unauthorized parties may attempt to copy or otherwise obtain and use our proprietary technology. Monitoring unauthorized use of our technology is difficult, and we cannot be certain that the steps we have taken will prevent unauthorized use of our technology, particularly in foreign countries where the laws may not protect our proprietary rights as fully as in the United States. We cannot be certain that patents will be issued as a result of our pending applications nor can we be certain that any issued patents would protect or benefit us or give us adequate protection from competing products. For example, issued patents may be circumvented or challenged and declared invalid or unenforceable. We also cannot be certain that others will not develop effective competing technologies on their own.

**The semiconductor manufacturing process is highly complex and, from time to time, manufacturing yields may fall below our expectations, which could result in our inability to satisfy demand for our products in a timely manner**

The manufacture of our products is a highly complex and technologically demanding process. Although we work closely with our foundries to minimize the likelihood of reduced manufacturing yields, our foundries from time to time have experienced lower than anticipated manufacturing yields. Changes in manufacturing processes or the inadvertent use of defective or contaminated materials by our foundries could result in lower than anticipated manufacturing yields or unacceptable performance deficiencies, which could lower our gross profits. If our foundries fail to deliver fabricated silicon wafers of satisfactory quality in a timely manner, we will be unable to meet our customers' demand for our products in a timely manner, which would adversely affect our operating results and damage our customer relationships.

**We depend on our customers to support our products, and some of our customers offer competing products**

Our products are currently used by our customers to produce modems, telephony equipment, mobile handsets, networking equipment and a broad range of other devices. We rely on our customers to provide hardware, software, intellectual property indemnification and other technical support for the products supplied by our customers. If our customers do not provide the required functionality or if our customers do not provide satisfactory support for their products, the demand for these devices that incorporate our products may diminish or we may otherwise be materially adversely affected. Any reduction in the demand for these devices would significantly reduce our revenues.

In certain products such as the DAA, some of our customers offer their own competitive products. These customers may find it advantageous to support their own offerings in the marketplace in lieu of promoting our products.

**We could seek to raise additional capital in the future through the issuance of equity or debt securities, but additional capital may not be available on terms acceptable to us, or at all**

We believe that our existing cash, cash equivalents and investments will be sufficient to meet our working capital needs, capital expenditures, investment requirements and commitments for at least the next 12 months. However, it is possible that we may need to raise additional funds to finance our activities or to facilitate acquisitions of other businesses, products, intellectual property or technologies. We believe we could raise these funds, if needed, by selling equity or debt securities to the public or to selected investors. In addition, even though we may not need additional funds, we may still elect to sell additional equity or debt securities or obtain credit facilities for other reasons. However, we may not be able to obtain additional funds on favorable terms, or at all. If we decide to raise additional funds by issuing equity or convertible debt securities, the ownership percentages of existing shareholders would be reduced.

**We are a relatively small company with limited resources compared to some of our current and potential competitors and we may not be able to compete effectively and increase market share**

Some of our current and potential competitors have longer operating histories, significantly greater resources and name recognition and a larger base of customers than we have. As a result, these competitors may have greater credibility with our existing and potential customers. They also may be able to adopt more aggressive pricing policies and devote greater resources to the development, promotion and sale of their products than we can to ours. In addition, some of our current and potential competitors have already established supplier or joint development relationships with the decision makers at our current or potential customers. These competitors may be able to leverage their existing relationships to discourage their customers from purchasing products from us or persuade them to replace our products with their products. Our competitors may also offer bundled chipset kit arrangements offering a more complete product despite the technical merits or advantages of our products. These competitors may elect not to support our products which could complicate our sales efforts. These and other competitive pressures may prevent us from competing successfully against current or future competitors, and may materially harm our business. Competition could decrease our prices, reduce our sales, lower our gross profits or decrease our market share.

**Provisions in our charter documents and Delaware law could prevent, delay or impede a change in control of us and may reduce the market price of our common stock**

Provisions of our certificate of incorporation and bylaws could have the effect of discouraging, delaying or preventing a merger or acquisition that a stockholder may consider favorable. For example, our certificate of incorporation and bylaws provide for:

- The division of our Board of Directors into three classes to be elected on a staggered basis, one class each year;
- The ability of our Board of Directors to issue shares of our preferred stock in one or more series without further authorization of our stockholders;
- A prohibition on stockholder action by written consent;
- Elimination of the right of stockholders to call a special meeting of stockholders;
- A requirement that stockholders provide advance notice of any stockholder nominations of directors or any proposal of new business to be considered at any meeting of stockholders; and
- A requirement that a supermajority vote be obtained to amend or repeal certain provisions of our certificate of incorporation.

We also are subject to the anti-takeover laws of Delaware which may discourage, delay or prevent someone from acquiring or merging with us, which may adversely affect the market price of our common stock.

**Risks related to our industry**

**We are subject to the cyclical nature of the semiconductor industry, which has been subject to significant fluctuations**

The semiconductor industry is highly cyclical and is characterized by constant and rapid technological change, rapid product obsolescence and price erosion, evolving standards, short product life cycles and wide fluctuations in product supply and demand. The industry has experienced significant fluctuations, often connected with, or in anticipation of, maturing product cycles and new product introductions of both semiconductor companies and their customers products and fluctuations in general economic conditions.

Downturns have been characterized by diminished product demand, production overcapacity, high inventory levels and accelerated erosion of average selling prices. For example, in fiscal 2001, the semiconductor industry suffered a downturn due to reductions in the actual unit sales of personal computers and wireless phones as compared to previous robust forecasts. This downturn resulted in a material adverse effect on our business and operating results in fiscal 2001.

Upturns have been characterized by increased product demand and production capacity constraints created by increased competition for access to third-party foundry, assembly and test capacity. We are dependent on the availability of such capacity to manufacture, assemble and test our ICs. None of our third-party foundry, assembly or test subcontractors have provided assurances that adequate capacity will be available to us.

**The average selling prices of our products could decrease rapidly which may negatively impact our revenues and gross profits**

We may experience substantial period-to-period fluctuations in future operating results due to the erosion of our average selling prices. We have reduced the average unit price of our products in anticipation of or in response to competitive pricing pressures, new product introductions by us or our competitors and other factors. If we are unable to offset any such reductions in our average selling prices by increasing our sales volumes, increasing our sales content per application or reducing production costs, our gross profits and revenues will suffer. To maintain our gross profit percentage, we will need to develop and introduce new products and product enhancements on a timely basis and continually reduce our costs. Our failure to do so would cause our revenues and gross profit percentage to decline.

**Competition within the numerous markets we target may reduce sales of our products and reduce our market share**

The markets for semiconductors in general, and for mixed-signal ICs in particular, are intensely competitive. We expect that the market for our products will continually evolve and will be subject to rapid technological change. In addition, as we target and supply products to numerous markets and applications, we face competition from a relatively large number of competitors. We compete with Analog Devices, Atmel, Broadcom, Conexant, Cypress, Epson, Freescale, Fujitsu, Infineon Technologies, Legerity, LSI, Maxim Integrated Products, MediaTek, Microchip, National Semiconductor, NXP Semiconductors, Renesas, Texas Instruments, Vectron International and others. We expect to face competition in the future from our current competitors, other manufacturers and designers of semiconductors, and start-up semiconductor design companies. As the markets for communications products grow, we also may face competition from traditional communications device companies. These companies may enter the mixed-signal semiconductor market by introducing their own ICs or by entering into strategic relationships with or acquiring other existing providers of semiconductor products. In addition, large companies may restructure their operations to create separate companies or may acquire new businesses that are focused on providing the types of products we produce or acquire our customers.

**Our products must conform to industry standards and technology in order to be accepted by end users in our markets**

Generally, our products comprise only a part of a device. All components of such devices must uniformly comply with industry standards in order to operate efficiently together. We depend on companies that provide other components of the devices to support prevailing industry standards. Many of these companies are significantly larger and more influential in affecting industry standards than we are. Some industry standards may not be widely adopted or implemented uniformly, and competing standards may emerge that may be preferred by our customers or end users. If larger companies do not support the same industry standards that we do, or if competing standards emerge, market acceptance of our products could be adversely affected which would harm our business.

Products for certain applications are based on industry standards that are continually evolving. Our ability to compete in the future will depend on our ability to identify and ensure compliance with these evolving industry standards. The emergence of new industry standards could render our products incompatible with products developed by other suppliers. As a result, we could be required to invest significant time and effort and to incur significant expense to redesign our products to ensure compliance with relevant standards. If our products are not in compliance with prevailing industry standards for a significant period of time, we could miss opportunities to achieve crucial design wins.

Our pursuit of necessary technological advances may require substantial time and expense. We may not be successful in developing or using new technologies or in developing new products or product enhancements that achieve market acceptance. If our ICs fail to achieve market acceptance, our growth prospects, operating results and competitive position could be adversely affected.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

Our registration statement (Registration No. 333-94853) under the Securities Act of 1933, as amended, relating to our initial public offering of our common stock became effective on March 23, 2000.

The following table summarizes repurchases of our common stock during the three months ended June 30, 2007:

Period		Total Number of Shares Purchased (1)	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs
April 1, 2007	April 28, 2007	96,502	\$ 29.86	95,000	\$ 32,535,982
April 29, 2007	May 26, 2007	4,201	\$ 34.62	-	\$ 32,535,982
May 27, 2007	June 30, 2007	31,090	\$ 32.99	30,000	\$ 31,547,681
Total		131,793	\$ 30.75	125,000	

(1) Includes 6,793 shares of our common stock withheld by us to satisfy employee tax obligations upon vesting of certain stock grants made under our 2000 Stock Incentive Plan.

In July 2006, our board of directors authorized a program to repurchase up to \$100 million of our common stock over a twelve-month period. The program allowed for repurchases to be made in the open market subject to market conditions, applicable legal requirements and other factors.

**Item 3. Defaults Upon Senior Securities**

Not applicable

**Item 4. Submission of Matters to a Vote of Security Holders**

On April 19, 2007, we held our Annual Meeting of Shareholders. The matters voted upon at the meeting and the results of those votes were as follows:

Election of Class III Director

	Total Votes For Director	Total Votes Withheld From Director
Robert Ted Enloe, III	52,711,991	175,078

Ratification of the appointment of Ernst & Young LLP as independent auditors for the fiscal year ending December 29, 2007.

Votes For	Votes Against	Votes Abstaining	Broker Non-Votes
52,616,989	264,240	5,840	



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The following individuals, who were not up for election at this Annual Meeting of Shareholders, continue to serve as directors: Navdeep S. Sookh, Necip Sayiner, David R. Welland, Harvey B. Cash, Laurence G. Walker and William P. Wood.

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**Item 5. Other Information**

Not applicable

**Item 6. Exhibits**

The following exhibits are filed as part of this report:

**Exhibit**

**Number**

- |    |     |   |
|----|-----|---|
| 2  | .1* | Agreement and Plan of Merger, dated August 19, 2005, by and among Silicon Laboratories Inc., Sabine Merger Sub, Inc., and Silicon MAGIKE, Inc. (filed as Exhibit 2.1 to the Form 8-K filed August 22, 2005).  |
| 3  | .1* | Form of Fourth Amended and Restated Certificate of Incorporation of Silicon Laboratories Inc. (filed as Exhibit 3.1 to the Registrant's Registration Statement on Form S-1 (Securities and Exchange Commission File No. 333-94853) (the "IPO Registration Statement")). |
| 3  | .2* | Second Amended and Restated Bylaws of Silicon Laboratories Inc (filed as Exhibit 3.2 to the Registrant's Annual Report on Form 10-K for the fiscal year ended January 3, 2004).   |
| 4  | .1* | Specimen certificate for shares of common stock (filed as Exhibit 4.1 to the IPO Registration Statement).   |
| 31 | .1  | Certification of the Principal Executive Officer, as required by Section 302 of the Sarbanes-Oxley Act of 2002.   |
| 31 | .2  | Certification of the Principal Accounting Officer, as required by Section 302 of the Sarbanes-Oxley Act of 2002.  |
| 32 | .1  | Certification as required by Section 906 of the Sarbanes-Oxley Act of 2002.   |

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\* Incorporated herein by reference to the indicated filing.

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**SIGNATURES**

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

SILICON LABORATORIES INC.

July 25, 2007  
Date

/s/ Necip Sayiner  
Necip Sayiner  
*President and  
Chief Executive Officer  
(Principal Executive Officer)*

July 25, 2007  
Date

/s/ William G. Bock  
William G. Bock  
*Senior Vice President and  
Chief Financial Officer  
(Principal Financial Officer)*