

MICROTUNE INC
Form 10-Q
May 02, 2005
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-Q

(Mark one)

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

FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2005

OR

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

FOR THE TRANSITION PERIOD FROM _____ TO _____

Commission file number 000-31029-40

MICROTUNE, INC.

(Exact name of registrant as specified in its charter)

Edgar Filing: MICROTUNE INC - Form 10-Q

Delaware
(State or other jurisdiction of
Incorporation or organization)

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

2201 10th Street

Plano, Texas 75074

(Address of principal executive office and zip code)

(972) 673-1600

(Registrant's telephone number, including area code)

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

Indicate by check mark whether the Registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). YES NO

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date. As of April 22, 2005, approximately 51,999,758 shares of the Registrant's Common Stock, \$0.001 par value per share, were outstanding.

Table of Contents

Microtune, Inc.

FORM 10-Q

March 31, 2005

INDEX

| | Page |
|---|-------------|
| <u>Part I. Financial Information</u> | |
| <u>Item 1. Financial Statements</u> | 3 |
| <u>Consolidated Balance Sheets at March 31, 2005 and December 31, 2004 (unaudited)</u> | 3 |
| <u>Consolidated Statements of Operations for the Three Months Ended March 31, 2005 and 2004 (unaudited)</u> | 4 |
| <u>Consolidated Statements of Cash Flows for the Three Months Ended March 31, 2005 and 2004 (unaudited)</u> | 5 |
| <u>Notes to Consolidated Financial Statements (unaudited)</u> | 6 |
| <u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 16 |
| <u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u> | 35 |
| <u>Item 4. Controls and Procedures</u> | 35 |
| <u>Part II. Other Information</u> | |
| <u>Item 1. Legal Proceedings</u> | 35 |
| <u>Item 6. Exhibits</u> | 36 |
| <u>Signatures</u> | 37 |

Caution Regarding Forward-Looking Statements

Throughout this quarterly report on Form 10-Q, we make forward-looking statements that are based upon our current expectations, estimates and projections about our business and our industry, and that reflect our beliefs and assumptions based upon information available to us at the date of this report. In some cases, you can identify these statements by words such as if, may, might, will, should, expects, plans, anticipates, estimates, predicts, potential, continue, and other similar terms. These forward-looking statements include, among other things, projections of our future financial performance and our anticipated growth, descriptions of our strategies, our product and market development plans, the trends we anticipate in our businesses and the markets in which we operate, and the competitive nature and anticipated growth of those markets.

We caution readers that forward-looking statements are only predictions, based on our current expectations about future events. These forward-looking statements are not guarantees of future performance and are subject to risks, uncertainties and assumptions that are difficult to predict. Our actual results, performance or achievements could differ materially from those expressed or implied by the forward-looking statements. In addition to the other information in this report, we encourage you to review the information regarding the risks and uncertainties associated with our business set forth under the caption *Factors Affecting Future Operating Results and Stock Price* below and in our other

Edgar Filing: MICROTUNE INC - Form 10-Q

filings with the United States Securities and Exchange Commission (SEC). We caution readers not to rely on these forward-looking statements, which reflect management's analysis only as of the date of this report. We undertake no obligation to revise or update any forward-looking statement for any reason.

Table of Contents**PART I.****Financial Information****Item 1. Financial Statements****Microtune, Inc.****Consolidated Balance Sheets****(In thousands, except per share data)****(unaudited)**

| | March 31, 2005 | December 31, 2004 |
|---|---------------------------|------------------------------|
| | _____ | _____ |
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 12,568 | \$ 34,515 |
| Short-term investments | 61,953 | 44,460 |
| Accounts receivable, net | 6,242 | 5,738 |
| Inventories | 6,220 | 7,095 |
| Other current assets | 1,362 | 1,607 |
| | _____ | _____ |
| Total current assets | 88,345 | 93,415 |
| Property and equipment, net | 5,293 | 5,536 |
| Long-term investments | 3,561 | 3,587 |
| Intangible assets, net | 1,334 | 2,008 |
| Other assets and deferred charges | 2,050 | 209 |
| | _____ | _____ |
| Total assets | \$ 100,583 | \$ 104,755 |
| | _____ | _____ |
| Liabilities and Stockholders Equity | | |
| Current liabilities: | | |
| Accounts payable | \$ 4,216 | \$ 5,498 |
| Accrued compensation | 1,438 | 1,557 |
| Accrued expenses | 2,198 | 3,009 |
| Deferred revenue | | 17 |
| | _____ | _____ |
| Total current liabilities | 7,852 | 10,081 |
| Other non-current liabilities | 30 | 29 |
| Commitments and contingencies | | |
| Stockholders equity: | | |
| Preferred stock, \$0.001 par value Authorized 25,000 shares; issued and outstanding shares none | | |
| Common stock, \$0.001 par value Authorized 150,000 shares; issued and outstanding shares 51,990 and 51,953 respectively | 52 | 52 |
| Additional paid-in capital | 437,615 | 437,539 |
| Unearned stock compensation | (158) | (176) |

Edgar Filing: MICROTUNE INC - Form 10-Q

| | | |
|--|-------------------|-------------------|
| Accumulated other comprehensive loss | (1,094) | (1,061) |
| Accumulated deficit | (343,714) | (341,709) |
| | <u> </u> | <u> </u> |
| Total stockholders' equity | 92,701 | 94,645 |
| | <u> </u> | <u> </u> |
| Total liabilities and stockholders' equity | \$ 100,583 | \$ 104,755 |
| | <u> </u> | <u> </u> |

See accompanying notes.

Table of Contents**Consolidated Statements of Operations****(In thousands, except per share data)****(unaudited)**

| | Three Months Ended March 31, | |
|---|---|-------------|
| | 2005 | 2004 |
| Net revenue | \$ 12,181 | \$ 11,039 |
| Cost of revenue | 5,815 | 5,923 |
| Gross margin | 6,366 | 5,116 |
| Operating expenses: | | |
| Research and development: | | |
| Stock option compensation | 16 | 178 |
| Other | 3,987 | 3,384 |
| | 4,003 | 3,562 |
| Selling, general and administrative: | | |
| Stock option compensation | 2 | 80 |
| Other | 4,100 | 8,243 |
| | 4,102 | 8,323 |
| Restructuring | | 111 |
| Amortization of intangible assets | 674 | 1,066 |
| Total operating expenses | 8,779 | 13,062 |
| Loss from operations | (2,413) | (7,946) |
| Other income (expense): | | |
| Interest income | 505 | 215 |
| Foreign currency gains (losses), net | (110) | (1,208) |
| Other | 56 | 309 |
| Loss before provision for income taxes | (1,962) | (8,630) |
| Income tax expense | 43 | 100 |
| Net loss | \$ (2,005) | \$ (8,730) |
| Basic and diluted loss per common share | \$ (0.04) | \$ (0.17) |
| Weighted-average shares used in computing basic and diluted loss per common share | 51,977 | 51,399 |

See accompanying notes.

Table of Contents**Consolidated Statements of Cash Flows****(In thousands)****(unaudited)**

| | Three Months Ended March 31, | |
|---|---|-------------|
| | 2005 | 2004 |
| Operating activities: | | |
| Net loss | \$ (2,005) | \$ (8,730) |
| Adjustments to reconcile net loss to cash used in operating activities: | | |
| Depreciation | 514 | 662 |
| Amortization of intangible assets | 674 | 1,066 |
| Non-cash restructuring costs | | (2) |
| Foreign currency losses, net | 110 | 1,208 |
| Stock option compensation | 18 | 258 |
| Gain on sale of property and equipment | (49) | (264) |
| Changes in operating assets and liabilities: | | |
| Accounts receivable, net | (504) | (770) |
| Inventories | 875 | 942 |
| Other assets | (1,596) | 728 |
| Accounts payable | (1,282) | (2,402) |
| Accrued expenses | (828) | (1,081) |
| Accrued compensation | (119) | 153 |
| Other liabilities | 1 | (2) |
| Net cash used in operating activities | (4,191) | (8,234) |
| Investing activities: | | |
| Purchases of property and equipment | (273) | (72) |
| Proceeds from sale of assets | 51 | 317 |
| Proceeds from sale of available-for-sale investments | 7,500 | 9,000 |
| Purchase of available-for-sale investments | (25,000) | |
| Acquisition of intangible assets | | (47) |
| Net cash provided by (used in) investing activities | (17,722) | 9,198 |
| Financing activities: | | |
| Proceeds from issuance of common stock | 76 | 263 |
| Proceeds from loans receivable from stockholders | | 25 |
| Other, net | | (5) |
| Net cash provided by financing activities | 76 | 283 |
| Effect of foreign currency exchange rate changes on cash | (110) | (1,208) |
| Net increase (decrease) in cash and cash equivalents | (21,947) | 39 |
| Cash and cash equivalents at beginning of period | 34,515 | 22,637 |
| Cash and cash equivalents at end of period | \$ 12,568 | \$ 22,676 |

Edgar Filing: MICROTUNE INC - Form 10-Q

See accompanying notes.

Table of Contents

Notes to Consolidated Financial Statements

March 31, 2005

(unaudited)

1. Summary of Significant Accounting Policies

Description of Business

Microtune, Inc. began operations in August 1996. We operate in a single industry segment: designing and marketing radio frequency (RF) integrated circuits and subsystem module solutions for the worldwide consumer electronics/broadband communications and transportation electronics market.

General

The accompanying unaudited financial statements as of and for the first quarter of 2005 and 2004 have been prepared by us, pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States (GAAP) have been condensed or omitted pursuant to such rules and regulations. These unaudited consolidated financial statements should be read in conjunction with the audited financial statements and the notes thereto included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2004.

In the opinion of management, all adjustments which are of a normal and recurring nature and are necessary for a fair presentation of the financial position, results of operations, and cash flows as of and for the first quarter of 2005 and 2004 have been made. Results of operations for the first quarter of 2005 and 2004 are not necessarily indicative of results of operations to be expected for the entire year or any other period.

Risk and Uncertainties

Our future results of operations and financial condition will be impacted by the following factors, among others: dependence on the consumer electronics/broadband communications and transportation electronics markets, on a few significant customers, on third party manufacturers and subcontractors, on third party distributors in certain markets, and on the successful development of products and marketing of new products. Our future results also may be impacted by foreign currency fluctuations as a result of our international operations, intellectual property litigation, other litigation costs and product warranty liability and line down clauses.

Consolidation

Edgar Filing: MICROTUNE INC - Form 10-Q

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

Reclassifications

Certain prior year amounts have been reclassified to conform to current year presentation.

Use of Estimates

We make estimates, judgments and assumptions that affect the amounts reported in the financial statements and the disclosures made in the accompanying notes, including inventory valuation allowances, warranty costs, determining the collectibility of accounts receivable, the valuation of deferred tax assets, contingent liabilities and other amounts. We also use estimates, judgments and assumptions to determine the remaining economic lives and carrying values of purchased intangible assets, property and equipment and other long-lived assets. We believe that the estimates, judgments and assumptions upon which we rely are appropriate and correct, based upon information available to us at the time that they are made. These estimates, judgments and assumptions can affect our reported assets and liabilities as of the date of the financial statements, as well as the reported revenue and expense during the periods presented. If there are material differences between these estimates, judgments or assumptions and actual facts, our financial statements will be affected.

Cash and Cash Equivalents

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

Table of Contents

Investments

Our investments are comprised of high-quality securities in accordance with our investment policy. Investments in debt securities are classified as held-to-maturity when we intend to hold them to maturity. Held-to-maturity investments are carried at amortized cost with the amortization of the purchase discount recorded in interest income. Investments in debt securities not classified as held-to-maturity and equity securities are classified as available-for-sale and carried at fair value, with unrealized gains and losses, net of tax, recorded in stockholders' equity. Realized gains and losses and other than temporary declines in value, if any, on available-for-sale securities are reported in other income and expense as incurred. Our short-term investments, which consist of corporate debt securities and other debt securities issued by U.S. government and state agencies, including auction-rate securities, include \$57.0 million of available-for-sale investments and \$5.0 million of held-to-maturity investments. The auction-rate securities in established markets are available to support current operations and are classified as short-term investments although their contractual maturities are greater than 10 years. Our long-term investments, which consist of debt securities issued by U.S. government agencies, are classified as held-to-maturity and are due within 2 years from March 31, 2005. The carrying values of our investments approximate their fair values. Our investments are reviewed periodically for other-than-temporary impairment. At March 31, 2005, our investments had unrealized losses of approximately \$0.1 million and were in a continuous loss position for less than one year.

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 for bad debts against amounts due to us and reduce the net recognized receivable to the amount we reasonably believe will be collected. For all other customers, we recognize allowances for doubtful accounts based on the length of time the receivables are outstanding compared to contractual terms, industry and geographic concentrations, the current business environment and our historical experience. Accounts receivable included in the allowance for doubtful accounts are written-off after final collection efforts are exhausted. If the financial condition of our customers deteriorates or if economic conditions worsen, increases in the allowance may be required in the future. We cannot predict future changes in the financial stability of our customers, and there can be no assurance that our allowance will be adequate. If actual credit losses are significantly greater than the allowance we have established, our general and administrative expenses would increase and our reported net income would decrease. Conversely, if our actual credit losses are significantly less than our allowance, our general and administrative expenses would eventually decrease and our reported net income would eventually increase.

Inventory Valuation

Our inventories are stated at the lower of standard cost, which approximates actual cost, or estimated realizable value. Adjustments to reduce our inventories to estimated realizable value, including allowances for excess and obsolete inventories, are determined quarterly by comparing inventory levels of individual materials and parts to current backlog and estimated future sales. Actual amounts realized upon the sale of inventories may differ from estimates used to determine inventory valuation allowances due to changes in customer demand, technology changes and other factors.

Property and Equipment

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

Intangible Assets

Our intangible assets, which consist primarily of acquired patents and customer base, have been recorded as the result of our business or asset acquisitions. The remaining unamortized intangible assets are being amortized on the straight-line basis over 3 years.

Impairment of Long-lived Assets

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

Table of Contents

Revenue Recognition

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

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

For certain of our customers, we do not recognize revenue until receipt of payment because collection is not probable or the amount we will ultimately collect is not determinable at the date of the shipment. Upon shipment of product to these customers, title to the inventory transfers to the customer and the customer is invoiced. We account for these transactions by recording accounts receivable for the sales value of the shipments, as the shipments represent valid receivables, and reducing inventory for the cost of the inventory shipped. The difference, representing the gross margin on the transactions, is recorded as deferred revenue. For financial statement presentation purposes, this deferred revenue balance is offset against the corresponding accounts receivable balance from the customer. When payment is received for the transaction, revenue is recognized for the value of the cash payment, cost of sales is recorded for the cost of the inventory and the deferred revenue is relieved for the gross margin on the transaction. At March 31, 2005 and 2004, the sales value of products shipped for which revenue was deferred was approximately \$0.2 million and \$0.3 million, respectively.

When we defer revenue, the timing and amount of revenue we ultimately recognize is determined upon our receipt of payment, which can result in significant fluctuations in revenues from period to period. In the first quarter of 2005 and 2004, we recognized 6% and 12% of our net revenue upon receipt of payment, respectively.

We also defer revenue when customers have made payments and we have not completed the earnings process. These payments are reflected as liabilities in our financial statements as deferred revenue. In these instances, once the product is shipped, title has transferred to our customer and the earnings process is complete, we recognize revenue. At March 31, 2005, we had no deferred revenue as a result of customer prepayments. Deferred revenue as a result of customer prepayments was insignificant as of December 31, 2004.

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

Research and Development Costs

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

Shipping and Handling Costs

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

Table of Contents**Warranty Costs**

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

Foreign Currency Gains and Losses

Our functional currency is the U.S. dollar. The impact from the re-measurement of accounts not denominated in U.S. dollars is recognized currently in our results of operations as a component of foreign currency gains and losses. Foreign currency losses, net were \$0.1 million and \$1.2 million for the first quarter of 2005 and 2004, respectively.

Income Taxes

Our income taxes are computed using the asset and liability method of accounting. Under the asset and liability method, a deferred tax asset or liability is recognized for estimated future tax effects attributable to temporary differences and carryforwards. The measurement of deferred income tax assets is adjusted by a valuation allowance, if necessary, to recognize future tax benefits only to the extent, based on available evidence, it is more likely than not such benefits will be realized. Our deferred tax assets were fully reserved at March 31, 2005 and December 31, 2004.

Earnings Per Share

Basic earnings (loss) per common share is computed by dividing net income (loss) by the weighted average number of common shares outstanding during each period. Diluted earnings (loss) per common share is computed by dividing net income (loss) by the weighted average number of common shares outstanding during each period and dilutive common equivalent shares consisting of stock options and restricted stock subject to repurchase rights and employee stock purchase plan options. All potentially dilutive common equivalent shares are anti-dilutive and were excluded from diluted loss per common share for the first quarter of 2005 and 2004.

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

| | <u>March 31,</u> | |
|------------------------------|------------------|-------------|
| | <u>2005</u> | <u>2004</u> |
| Stock options | 6,777 | 6,563 |
| Restricted common stock | | 7 |
| Employee stock purchase plan | 154 | 60 |

| | | |
|---|-------|-------|
| Total anti-dilutive securities excluded | 6,931 | 6,630 |
|---|-------|-------|

Stock-Based Compensation

At March 31, 2005, we have four stock-based compensation plans covering employees and directors. We have elected to follow Accounting Principles Board Opinion (APB) No. 25, *Accounting for Stock Issued to Employees*, and related interpretations in accounting for our employee stock options. We account for stock-based compensation for non-employees under the fair value method prescribed by SFAS No. 123, *Accounting for Stock-Based Compensation* (SFAS No. 123). Through March 31, 2005, there have been no significant grants to non-employees.

Stock option compensation expense results from grants of stock options with deemed exercise prices below the estimated fair value per share of our common stock at the date of grant under the provisions of APB No. 25. Stock option compensation expense was insignificant in the first quarter of 2005. In the first quarter of 2004, under the provisions of APB No. 25, we recorded stock option compensation expense of approximately \$0.3 million. Stock option compensation is deferred and amortized as a charge to operations over the vesting period of the related options. As of March 31, 2005 and December 31, 2004, unearned deferred stock compensation was \$0.2 million, respectively. The weighted average remaining vesting period of outstanding compensatory stock options was less than one year at March 31, 2005.

During the quarter ended March 31, 2005, we granted our employees approximately 92,000 stock options with exercise prices ranging from \$4.48 to \$5.31 per share. The stock options generally vest over the next three to five years. In addition, we issued approximately 36,000 shares of common stock upon exercise of stock options by employees pursuant to our stock-based compensations plans during the quarter ended March 31, 2005.

Table of Contents

Although SFAS No. 123 allows us to continue to follow the present APB No. 25 guidelines, we are required to disclose pro forma net income (loss) and net income (loss) per share as if we had adopted SFAS No. 123. The pro forma impact of applying SFAS No. 123 will not necessarily be representative of the pro forma impact in future periods. Our pro forma information is as follows (in thousands, except per share data):

| | Three Months Ended March 31, | |
|--|---------------------------------|-------------|
| | 2005 | 2004 |
| Net loss, as reported | \$ (2,005) | \$ (8,730) |
| Add stock compensation expense recorded under the intrinsic value method | 18 | 258 |
| Less pro forma stock compensation expense computed under the fair value method | (1,385) | (2,746) |
| Pro forma net loss | \$ (3,372) | \$ (11,218) |
| Basic and diluted pro forma loss per common share | \$ (0.06) | \$ (0.22) |

In December 2004, the FASB issued SFAS No. 123R, *Share-Based Payment*. SFAS No. 123R is a revision of SFAS No. 123, *Accounting for Stock Based Compensation*, and supersedes APB 25. Among other items, SFAS 123R eliminates the use of APB 25 and the intrinsic value method of accounting, and requires companies to recognize the cost of employee services received in exchange for awards of equity instruments, based on the grant date fair value of those awards, in the financial statements. As recently amended, the effective date of SFAS 123R is the beginning of the first fiscal year beginning after June 15, 2005, which is first quarter 2006 for calendar year companies, although early adoption is allowed. We believe adopting this amendment will have a material impact on our consolidated results of operations and would approximate the impact of applying SFAS No. 123 as noted in the table above.

SFAS 123R permits companies to adopt its requirements using either a modified prospective method, or a modified retrospective method. Under the modified prospective method, compensation cost is recognized in the financial statements beginning with the effective date, based on the requirements of SFAS 123R for all share-based payments granted after that date, and based on the requirements of SFAS 123 for all unvested awards granted prior to the effective date of SFAS 123R. Under the modified retrospective method, the requirements are the same as under the modified prospective method, but also permits entities to restate financial statements of previous periods based on proforma disclosures made in accordance with SFAS 123.

We currently utilize a standard option pricing model (i.e., Black-Scholes) to measure the fair value of stock options granted to employees. While SFAS 123R permits entities to continue to use such a model, the standard also permits the use of a lattice model. We have not yet determined which model we will use to measure the fair value of employee stock options upon the adoption of SFAS 123R.

SFAS 123R also requires that the benefits associated with the tax deductions in excess of recognized compensation cost be reported as a financing cash flow, rather than as an operating cash flow as required under current accounting literature. This requirement will reduce net operating cash flows and increase net financing cash flows in periods after the effective date. These future amounts cannot be estimated, because they depend on, among other things, when employees exercise stock options.

We currently expect to adopt SFAS 123R effective January 1, 2006; however, we have not yet determined which of the aforementioned adoption methods we will use. We expect that the adoption of SFAS 123R on January 1, 2006 will have a material impact on future operating results.

Comprehensive Income

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

Risk Concentrations

Financial instruments that potentially expose Microtune to concentrations of credit risk consist primarily of trade accounts receivable. Products are sold to customers internationally, principally in Asia Pacific and Europe. We continually evaluate the creditworthiness of our customers financial condition and generally do not require collateral. At March 31, 2005, approximately 62% of our net accounts receivable were due from five of our customers. We evaluate the collectibility of our accounts receivable based on a combination of factors. In circumstances when we are aware of a specific customer's inability to meet its financial obligations to us, we record a specific reserve for bad debts against amounts due to us and reduce the net realizable receivable to the amount we reasonably believe will be collected. For all other customers, we recognize allowances for doubtful accounts based on the length of time the receivables are outstanding, industry and geographic concentrations, the current business environment and our historical experience. If the financial condition of our customers deteriorates or if economic conditions worsen, additional allowances may be required in the future. Historically, our bad debts have been insignificant and we are not currently aware of any significant uncollectible accounts. As a result, we have not recorded an allowance for doubtful accounts as of March 31, 2005.

Table of Contents

We depend on third party foundries to manufacture all of our integrated circuit products. We do not have long-term supply agreements with our foundries and obtain integrated circuit products on a purchase order basis. The inability of a third party foundry to continue manufacturing our integrated circuits would have a material adverse effect on our operations. We are also dependent upon third parties, some of whom are competitors, for the supply of components used in subsystem module manufacturing. Our failure to obtain components for module manufacturing would significantly impact our ability to ship modules to customers in a timely manner. Our products are primarily manufactured in the U.S., Korea and the Philippines.

We sold assets related to our Manila operations to Three-Five Systems (TFS) on March 27, 2003, and we use TFS for nearly all assembly and calibration functions for our subsystem module solutions. TFS has informed us it intends to sell the facility in which our products are manufactured. If a buyer for the facility is not found or if TFS were unable to continue manufacturing our subsystem modules, there would be a material adverse effect on our operations.

Commitments and Contingencies

We are subject to the possibility of loss contingencies for various legal matters. Our discussion of legal matters includes pending litigation and matters in which any party has manifested a present intention to commence litigation related to such matters. There can be no assurance that additional contingencies of a legal nature or having legal aspects will not be asserted in the future. Such matters could relate to prior transactions or events or future transactions and events. See Note 7. We regularly evaluate current information available to us to determine whether any provisions for loss should be made. If we ultimately determine that a provision for loss should be made for a legal matter, the provision for loss could have a material and adverse effect on our operating results and financial position.

Our future cash commitments are primarily for long-term facility leases. In April 2005, we extended our operating lease for office space in Plano, Texas an additional 10 years with certain rights of early termination, reducing the monthly base rent and providing a leasehold improvement allowance. Our lease in Germany for our administrative, sales and marketing and research and development facility has an option to purchase the facility during certain time periods during the lease. The lease has a twenty-two year term, which began in December 1999. See Note 7.

2. Accounts Receivable, net

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

| | March 31, 2005 | December 31, 2004 |
|---------------------------|---------------------------|------------------------------|
| | <u> </u> | <u> </u> |
| Gross accounts receivable | \$ 6,384 | \$ 5,803 |
| Deferred revenue | (142) | (65) |
| | <u> </u> | <u> </u> |
| Accounts receivable, net | \$ 6,242 | \$ 5,738 |
| | <u> </u> | <u> </u> |

3. Inventories

Inventories consist of the following (in thousands):

| | March 31, 2005 | December 31, 2004 |
|------------------------|---------------------------|------------------------------|
| Finished goods | \$ 3,724 | \$ 4,188 |
| Work-in-process | 2,496 | 2,907 |
| Total inventory | \$ 6,220 | \$ 7,095 |

4. Intangible Assets

Amortization expense on intangible assets was \$0.7 million and \$1.1 million for the first quarter of 2005 and 2004, respectively.

The gross carrying amounts and related accumulated amortization of intangible assets consist of the following (in thousands):

| | Remaining Weighted Average Useful Life in Years | March 31, 2005 | | December 31, 2004 | |
|--------------|--|--------------------------------------|--------------------------|--------------------------------------|--------------------------|
| | | Gross Carrying Amount | Accum. Amort. | Gross Carrying Amount | Accum. Amort. |
| Patents | 0.5 | 10,270 | 8,936 | 10,270 | 8,262 |
| Other | | 4,308 | 4,308 | 4,308 | 4,308 |
| Total | | \$ 14,578 | \$ 13,244 | \$ 14,578 | \$ 12,570 |

Table of Contents

The following table sets forth the estimated future amortization of intangible assets as of March 31, 2005 (in thousands):

| <u>Year Ending December 31,</u> | |
|---------------------------------|----------|
| 2005 | \$ 1,326 |
| 2006 | 8 |

5. Accrued Expenses

Accrued expenses consist of the following (in thousands):

| | <u>March 31,</u> <u>2005</u> | <u>December 31,</u> <u>2004</u> |
|---|---------------------------------|------------------------------------|
| Accrued non-cancelable purchase obligations | \$ 481 | \$ 1,513 |
| Accrued legal fees | 360 | 195 |
| Accrued payment for potential legal settlements | 381 | 381 |
| Other | 976 | 920 |
| Total accrued expenses | \$ 2,198 | \$ 3,009 |

The accrued non-cancelable inventory purchase obligations relate to inventories from TFS that became excess as a result of our canceling purchase orders placed with TFS, and non-cancelable orders to other subcontractors for inventories determined to be excess compared to current inventory levels, current backlog and estimated future sales. The accrued payment for potential litigation settlements relates to the estimated liability from the settlement agreements in our securities litigations. See Note 7. The accrued expenses are expected to be paid out during 2005.

6. Income Taxes

We have established a valuation allowance to fully reserve our deferred tax assets at March 31, 2005 and December 31, 2004 due to the uncertainty of the timing and amount of future taxable income. For U.S. federal income tax purposes, at December 31, 2004, we had a net operating loss carryforward of approximately \$174.9 million and an unused research and development credit carryforward of approximately \$4.5 million, that will begin to expire in 2011. A change in ownership, as defined in Section 382 of the Internal Revenue Code, may limit utilization of the U.S. federal net operating loss and research and development credit carryforwards.

The provision for taxes during the first quarter of 2005 and 2004 consists of foreign income taxes.

Our income tax returns and those of our subsidiaries are subject to review and examination in the various jurisdictions in which we operate. We believe that all income tax issues that have been or may be raised as a result of such reviews and examinations will be resolved with no material

impact on our financial position or future results of operations.

7. Commitments and Contingencies

Lease Commitments

In March 2000, we entered into a five-year operating lease for office space in Plano, Texas to be used as our headquarters, as well as for certain administrative, sales and marketing and research and development activities. In April 2005, we entered into an amendment to this lease extending the lease term an additional 10 years with certain rights of early termination, reducing the monthly base rent and providing a leasehold improvement allowance. We lease an administrative, sales and marketing, and research and development facility in Germany under an operating lease with a twenty-two year term, which began in December 1999. We also lease certain other facilities and equipment under operating leases. Future minimum lease payments required under operating leases as of March 31, 2005 and including the April 2005 lease extension for office space in Plano, Texas, are as follows (in thousands):

| <u>Year Ending December 31,</u> | |
|---------------------------------|------------------|
| 2005 | \$ 829 |
| 2006 | 1,077 |
| 2007 | 879 |
| 2008 | 873 |
| 2009 | 880 |
| Thereafter | 7,761 |
| | <u>\$ 12,299</u> |

Rent expense for the first quarter of 2005 and 2004 was \$0.3 million and \$0.5 million, respectively.

Table of Contents

Purchase Commitments

As of April 22, 2005, we had approximately \$13.7 million of cancelable and non-cancelable purchase commitments outstanding with our vendors. These commitments were entered into in the normal course of business.

Other Commitments

We are currently subject to "line down" clauses in some contracts with our customers. Such clauses require us to pay financial penalties if our failure to supply product in a timely manner causes the customer to slow down or stop their production. We are also subject to product liability clauses and/or intellectual property indemnification clauses in some of our customer contracts. Such clauses require us to pay financial penalties if we supply defective product, which results in financial damages to the customer, or to indemnify the customer for third party actions based on infringement by our product of other's intellectual property. As of March 31, 2005, we are unaware of any such claims by any of our customers.

Legal Proceedings

From time to time, we may be involved in routine legal proceedings, as well as demands, claims and threatened litigation that arise in the normal course of our business. The ultimate amount of liability, if any, for any pending claims of any type (either alone or combined) may materially and adversely affect our financial position, results of operations and liquidity. Moreover, the ultimate outcome of any pending litigation is uncertain. Any outcome, whether favorable or unfavorable, may materially and adversely affect us due to legal costs and expenses, diversion of management resources and other factors. There can be no assurance that additional contingencies of a legal nature or contingencies having legal aspects will not be asserted in the future. Such matters could relate to prior transactions or events or future transactions or events. Except as described below, we are not currently a party to any material litigation.

Intellectual Property Litigation

On January 24, 2001, we filed a lawsuit alleging patent infringement in the United States District Court for the Eastern District of Texas, Sherman Division, against Broadcom Corporation. The lawsuit alleged that Broadcom's BCM3415 microchip and related products infringe our U.S. Patent No. 5,737,035 ("035 patent"). In our complaint, we sought monetary damages resulting from the alleged infringement as well as injunctive relief precluding Broadcom from taking any further action that infringes our patent. On March 20, 2003, a jury found that certain Broadcom products do infringe Microtune's valid and enforceable patent and that the infringement was willful. An appeal of this verdict by Broadcom was dismissed under the terms of the settlement described below.

On April 24, 2003, Broadcom filed a *Complaint For Declaratory Judgment of Patent Noninfringement* in the United States District Court for the Eastern District of Texas, Sherman Division, against Microtune. Broadcom alleged that their BCM3416 and BCM93416 reference design did not infringe the "035 patent. This case was dismissed under the terms of the settlement described below.

Edgar Filing: MICROTUNE INC - Form 10-Q

In addition to the cases discussed above, Microtune and Broadcom were parties to five other proceedings relating to patent infringement and anti-trust litigation which were all dismissed under the terms of the settlement described below. See our 2004 Annual Report on Form 10-K for a description of these proceedings.

On June 13, 2004, Microtune and Broadcom entered into agreements to settle all outstanding patent and anti-trust litigation between the two companies. Under the terms of the settlement agreement, all outstanding claims in pending litigation were dismissed with prejudice. The settlement agreement also provides for reciprocal releases covering all asserted and unasserted claims between the parties. In addition, the permanent injunction described above was vacated. In connection with the settlement, Broadcom made a one-time payment to Microtune of \$22.5 million, which was recorded in other income in the second quarter of 2004. Additionally, Broadcom and Microtune entered into a separate patent cross-license agreement whereby patents claiming priority prior to the effective date of the license agreement are licensed for the lives of the patents, and subsequently acquired patents that claim priority within the following four years are licensed for ten years. Under the license agreement, all products of Broadcom are licensed under all of Microtune's patents, and all current products and future analog signal processing products of Microtune are licensed under all of Broadcom's analog signal processing and related foundational patents. The licenses are royalty free with the exception of Microtune's license to Broadcom for its dual conversion tuner products, which is royalty bearing.

In October 2003, Broadcom requested that the United States Patent and Trademark Office (USPTO) re-examine certain claims of the 035 patent in light of certain patent documents and publications considered by the Court in its determination that the claims of the patent were valid. The USPTO issued an order granting the re-examination proceeding on January 8, 2004. On September 14, 2004, the USPTO examiner assigned to the re-examination issued an action with respect to the patentability of the 035 claims undergoing re-examination, confirming certain claims of the 035 patent and rejecting others. We responded to the examiner

Table of Contents

presenting our arguments that these rejected claims are patentable and should be confirmed. While we intend to vigorously defend the patentability of the '035 patent claims in this re-examination, we are unable at this time to determine whether the outcome of this proceeding will have a material impact on the scope of the '035 patent or our business prospects in any future period. The settlement agreements discussed above have no impact on the USPTO re-examination.

Securities Litigation

Initial Public Offering Litigation

Starting on July 11, 2001, multiple purported securities fraud class action complaints were filed in the United States District Court for the Southern District of New York. We are aware of at least three such complaints: *Berger v. Goldman, Sachs & Co., Inc. et al.*; *Atlas v. Microtune et al.*; and *Ellis Investments Ltd. v. Goldman, Sachs & Co., Inc. et al.* The complaints are brought purportedly on behalf of all persons who purchased our common stock from August 4, 2000 through December 6, 2000 and are related to *In re Initial Public Offering Securities Litigation* (IPO cases). The Atlas complaint names as defendants Microtune; Douglas J. Bartek, our former Chairman and Chief Executive Officer; Everett Rogers, our former Chief Financial Officer and Vice President of Finance and Administration; and several investment banking firms that served as underwriters of our initial public offering. Microtune, Mr. Bartek and Mr. Rogers were served with notice of the Atlas complaint on August 22, 2001, however, they have not been served regarding the other referenced complaints. The Berger and Ellis Investment Ltd. complaints assert claims against the underwriters only. The complaints were consolidated and amended on May 29, 2002. The amended complaint alleges liability under §§ 11 and 15 of the Securities Act of 1933, as amended (1933 Act Claims) and §§ 10(b) and 20(a) of the Securities Exchange Act of 1934, as amended (1934 Act Claims), on the grounds that the registration statement for our initial public offering did not disclose that (1) the underwriters had agreed to allow certain of their customers to purchase shares in the offering in exchange for excess commissions paid to the underwriters, and (2) the underwriters had arranged for certain of their customers to purchase additional shares in the aftermarket at pre-determined prices. The amended complaint also alleges that false analyst reports were issued. No specific amount of damages is claimed. We are aware that similar allegations have been made in other lawsuits filed in the Southern District of New York challenging over 300 other initial public offerings and secondary offerings conducted in 1998, 1999 and 2000. Those cases have been consolidated for pretrial purposes before the Honorable Shira A. Scheindlin. On February 19, 2003, the Court ruled on all defendants' motions to dismiss. The Court denied the motions to dismiss the 1933 Act Claims. The Court did not dismiss the 1934 Act Claims against us and other issuers and underwriters.

We have accepted a settlement proposal presented to all issuer defendants. Under the settlement, plaintiffs will dismiss and release all claims against the Microtune defendants. The insurance companies collectively responsible for insuring the issuer defendants in all of the IPO cases will guarantee plaintiffs a recovery of \$1 billion, an amount that covers all of the IPO cases. Under this guarantee, the insurers will pay the difference, if any, between \$1 billion and the amount collected by the plaintiffs from the underwriter defendants in all of the IPO cases. The Microtune defendants will not be required to pay any money in the settlement. However, any payment made by the insurers will be charged to the respective insurance policies covering each issuer's case on a *pro rata* basis (that is, the total insurance company payments will be divided by the number of cases that settle). If the *pro rata* charge exceeds the amount of insurance coverage for an issuer, that issuer would be responsible for additional payments. The proposal also provides that the insurers will pay for the company's legal fees going forward. The settlement will require approval of the Court, which cannot be assured.

On February 15, 2005, the Court issued an order providing preliminary approval of the settlement except to the extent the settlement would have cut off contractual indemnification claims that underwriters may have against securities issuers, such as Microtune. The Court set a hearing to consider final approval of the settlement for January 9, 2006.

Class Action Litigation

Beginning in February 2003, Microtune, our former Chairman of the Board and Chief Executive Officer, Douglas J. Bartek, our former Chief Financial Officer and Vice-President of Finance and Administration, Everett Rogers, our former President and Chief Operating Officer, William L. Housley, and our former Chief Financial Officer and former General Counsel, Nancy A. Richardson, were named as defendants in several class action lawsuits filed in the United States District Court for the Eastern District of Texas. These suits allege violations of federal securities laws and regulations. The claims of the plaintiffs in the various lawsuits include that the defendants violated §§10(b) and 20(a) of the Securities Exchange Act of 1934, as amended, as well as SEC Rule 10b-5, resulting in damages to persons who purchased, converted, exchanged, or otherwise acquired our common stock between July 23, 2001 and February 20, 2003, inclusive. The plaintiffs' specific allegations include that the defendants engaged in fraudulent accounting and financial practices and misrepresented material facts and omitted to state material facts necessary to make other statements made not misleading, and that these misrepresentations or omissions had the effect of artificially inflating Microtune's stock price. The alleged misrepresentations and omissions include, among others, allegations that: Microtune materially overstated revenue by recognizing certain sales immediately as revenue when deferred revenue recognition would have been more appropriate; Microtune failed to establish reserves when appropriate; Microtune lacked adequate internal controls to assure its financial statements were fairly presented in conformity with generally accepted accounting principles; Microtune lacked sufficient controls and procedures for the

Table of Contents

timely and accurate issuance of periodic press releases; Microtune lacked sufficient means to monitor prior public statements to detect whether an update was required; and Microtune failed to record impairment charges relating to the assets acquired with the Transilica acquisition at the appropriate time.

On November 23, 2004, Microtune and the other defendants entered into a settlement agreement with the plaintiffs under which the defendants agreed to settle the consolidated lawsuit for \$5,625,000, inclusive of plaintiffs' attorneys' fees and costs, in return for a full release of all claims and dismissal of the consolidated lawsuit. On April 4, 2005, the district court entered an order of dismissal and final judgment which gave final approval to the securities class action litigation settlement. Microtune and the other defendants made no admission of wrongdoing as part of the settlement. The settlement is subject to appeal for thirty days from the date of final court approval.

Under a separate agreement with Microtune's director and officer insurance carriers, the insurance carriers have agreed to reimburse the settlement amount, subject to Microtune's 15% co-pay obligation. The settlement will not have a material impact on our business prospects, results of operations or financial condition. If the order of dismissal and final judgment is appealed, Microtune intends to vigorously defend the consolidated lawsuit.

Stockholder Derivative Litigation

Beginning on October 30, 2003, various stockholder derivative lawsuits were filed in the United States District Court for the Eastern District of Texas, against current and former officers and directors of Microtune. The derivative lawsuits were consolidated on January 5, 2004, and the consolidated suit was styled in re Microtune, Inc. Derivative Litigation, Master File No. 4:03CV409 (derivative litigation). The plaintiffs alleged various breaches of fiduciary duties, abuse of control, and waste of corporate assets against all the defendants for which they sought contribution and indemnification.

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

Under a separate agreement with Microtune's director and officer insurance carriers, the insurance carriers have agreed to reimburse the majority of the plaintiffs' attorneys' fees and expenses, subject to the Company's 15% co-pay obligation. The settlement will not have a material impact on our business prospects, results of operations or financial condition.

Directors' and Officers' Liability Insurance

If our directors' and officers' liability insurance is insufficient or unavailable to cover the amount of any damages that may result from pending and future securities litigation for any reason, we may be required to pay the costs of indemnifying and defending certain of our directors and officers. Directors' and officers' liability insurance may not be available to us in sufficient amounts to cover any claims made in securities litigation filed against us in the future.

Securities and Exchange Commission Investigation

On August 4, 2003, we received written notification that Microtune is the subject of an investigation by the Securities and Exchange Commission (SEC). The SEC advised Microtune that the process under way is a fact-finding investigation. The investigation relates directly to the internal inquiry commissioned by the Audit Committee of our Board in 2003. We are cooperating fully with the SEC, and we have had discussions with the SEC regarding possible settlement of this matter.

Other Contingencies

In January 2005, TFS informed us that it wishes to sell its Philippines facility in which our products are manufactured. If TFS is unable to sell the facility, we may experience a disruption in our supply of product.

8. Stockholders Equity

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

Table of Contents

owning 15 percent or more of our common stock. Each one one-thousandth of a share of the Series A has terms designed to make it substantially the economic equivalent of one share of our common stock. Prior to an entity acquiring 15 percent, the rights can be redeemed for \$0.001 each by action of our Board. Under certain circumstances, if an entity acquires 15 percent or more of our common stock, the rights permit our stockholders other than the acquirer to purchase our common stock having a market value of twice the exercise price of the rights, in lieu of the Series A. Alternatively, when the rights become exercisable, the Board may authorize the issuance of one share of our common stock in exchange for each right that is then exercisable. In addition, in the event of certain business combinations, the rights permit the purchase of the common stock of an acquirer at a 50 percent discount. Rights held by the acquirer will become null and void in both cases. The rights expire on March 3, 2012. On March 31, 2005, 51,989,757 rights were outstanding.

9. Geographic Information and Significant Customers

Our headquarters and main design center are located in Plano, Texas. We have other sales offices and design centers in the United States and other worldwide locations. Net income (loss) from foreign operations totaled \$0.2 million and \$(1.4) million for the first quarter of 2005 and 2004, respectively. Net revenue by geographical area is summarized below (in thousands):

| | Three Months Ended March 31, | |
|---------------|---------------------------------|------------------|
| | 2005 | 2004 |
| North America | \$ 5,375 | \$ 4,185 |
| Europe | 2,182 | 2,010 |
| Asia Pacific | 4,595 | 4,562 |
| Other | 29 | 282 |
| Total | \$ 12,181 | \$ 11,039 |

Sales to Scientific-Atlanta and Asuspower for the benefit of ARRIS and Terayon accounted for approximately 26% and 11%, respectively, of consolidated net revenue for the first quarter of 2005. Sales to DaimlerChrysler and Panasonic accounted for approximately 11% and 10%, respectively, of consolidated net revenue for the first quarter of 2004. We recognized 6% of our net revenue upon receipt of payment from our customers for the first quarter of 2005. Sales to our ten largest customers, including sales to their respective manufacturing subcontractors, accounted for approximately 72% and 62% of our net revenue for the first quarter of 2005 and 2004, respectively.

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

| | March 31, 2005 | December 31, 2004 |
|---------------|-------------------|----------------------|
| North America | \$ 3,866 | \$ 3,819 |
| Europe | 943 | 1,107 |
| Asia Pacific | 47 | 56 |
| Other | 437 | 554 |

| | | |
|-------|----------|----------|
| Total | \$ 5,293 | \$ 5,536 |
|-------|----------|----------|

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

Caution Regarding Forward-Looking Statements

Throughout this quarterly report on Form 10-Q, we make forward-looking statements that are based upon our current expectations, estimates and projections about our business and our industry, and that reflect our beliefs and assumptions based upon information available to us at the date of this report. In some cases, you can identify these statements by words such as if, may, might, will, should, expects, plans, anticipates, estimates, predicts, potential, continue, and other similar terms. These forward-looking statements include, among other things, projections of our future financial performance and our anticipated growth, descriptions of our strategies, our product and market development plans, the trends we anticipate in our businesses and the markets in which we operate, and the competitive nature and anticipated growth of those markets.

We caution readers that forward-looking statements are only predictions, based on our current expectations about future events. These forward-looking statements are not guarantees of future performance and are subject to risks, uncertainties and assumptions that are difficult to predict. Our actual results, performance or achievements could differ materially from those expressed or implied by the forward-looking statements. In addition to the other information in this report, we encourage you to review the information regarding the risks and uncertainties associated with our business set forth under the caption *Factors Affecting Future Operating Results and Stock Price* below and in our other filings with the United States Securities and Exchange Commission (SEC). We caution readers not to rely on these forward-looking statements, which reflect management's analysis only as of the date of this report. We undertake no obligation to revise or update any forward-looking statement for any reason.

Table of Contents

Overview

Microtune, Inc. was incorporated in 1996. We design and market radio frequency (RF) integrated circuits (IC) and subsystem module solutions for the worldwide consumer electronics/broadband communications and transportation electronics markets. Our products permit the delivery, reception and exchange of broadband video, audio and data using terrestrial (off-air) and/or cable communications systems. Our products, which include tuners, amplifiers and upconverters, are targeted for a range of applications, including handheld televisions; PC/TV multimedia products; cable TV set-top boxes; high-speed cable internet modems; analog, digital and high-definition televisions; in-car audio and video systems; and modems enabling cable-based digital phone services.

The consumer electronics/broadband communications market is intensely competitive and the market historically has seen rapid changes in demand. We may not be able to fully capitalize on increasing demand as we do not own production facilities and must compete for production capacity. We could be impacted more negatively than some of our competitors during times of decreasing demand because we may not be the primary supplier to some of our customers. This market is also characterized as having short product life cycles, due to rapid technological changes, resulting in rapidly decreasing average selling prices, making yield improvements and decreasing production costs for maturing products critical. The volatility of the consumer electronics/broadband communications market makes it difficult for us to discuss business trends or to predict future results.

Today, our products are marketed principally to original equipment manufacturers (OEMs) in the following markets:

Consumer Electronics/Broadband Communications

This market includes products that send and/or receive cable and terrestrial broadband signals. These products are designed for use in RF electronics from upconverters in the cable head-end to those in consumer devices, including handheld televisions; cable modems; cable telephony modems; analog, digital and high-definition televisions (including projection, Digital Light Processor (DLP), plasma and liquid crystal display (LCD) systems); VCRs; portable DVD players; digital and analog set-top boxes; digital personal video recorders; and PC/TV multimedia products.

Transportation Electronics

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

Critical Accounting Policies

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

Edgar Filing: MICROTUNE INC - Form 10-Q

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

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

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

Revenue Recognition

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

Table of Contents

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

For certain of our customers, we do not recognize revenue until receipt of payment because collection is not probable or the amount we will ultimately collect is not determinable at the date of the shipment. Upon shipment of product to these customers, title to the inventory transfers to the customer and the customer is invoiced. We account for these transactions by recording accounts receivable for the sales value of the shipments, as the shipments represent valid receivables, and reducing inventory for the cost of the inventory shipped. The difference, representing the gross margin on the transactions, is recorded as deferred revenue. For financial statement presentation purposes, this deferred revenue balance is offset against the corresponding accounts receivable balance from the customer. When payment is received for the transaction, revenue is recognized for the value of the cash payment, cost of sales is recorded for the cost of the inventory and the deferred revenue is relieved for the gross margin on the transaction. At March 31, 2005 and 2004, the sales value of products shipped for which revenue was deferred was approximately \$0.2 million and \$0.3 million, respectively.

When we defer revenue, the timing and amount of revenue we ultimately recognize is determined upon our receipt of payment, which can result in significant fluctuations in revenues from period to period. In the first quarter of 2005 and 2004, we recognized 6% and 12% of our net revenue upon receipt of payment, respectively.

We also defer revenue when customers have made payments and we have not completed the earnings process. These payments are reflected as liabilities in our financial statements as deferred revenue. In these instances, once the product is shipped and title has transferred to our customer, we recognize revenue. At March 31, 2005, we had no deferred revenue as a result of customer prepayments. Deferred revenue as a result of customer prepayments was insignificant as of December 31, 2004.

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

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 for bad debts against amounts due to us and reduce the net recognized receivable to the amount we reasonably believe will be collected. For all other customers, we recognize allowances for doubtful accounts based on the length of time the receivables are outstanding compared to contractual terms, industry and geographic concentrations, the current business environment and our historical experience. Accounts receivable included in the allowance for doubtful accounts are written-off

Edgar Filing: MICROTUNE INC - Form 10-Q

after final collection efforts are exhausted. If the financial condition of our customers deteriorates or if economic conditions worsen, increases in the allowance may be required in the future. We cannot predict future changes in the financial stability of our customers, and there can be no assurance that our allowance will be adequate. If actual credit losses are significantly greater than the allowance we have established, our general and administrative expenses would increase and our reported net income would decrease. Conversely, if our actual credit losses are significantly less than our allowance, our general and administrative expenses would eventually decrease and our reported net income would eventually increase.

Inventory Valuation

Our inventories are stated at the lower of standard cost, which approximates actual cost, or estimated realizable value. Adjustments to reduce our inventories to estimated realizable value, including allowances for excess and obsolete inventories, are determined quarterly by comparing inventory levels of individual materials and parts to current backlog and estimated future sales. Actual amounts realized upon the sale of inventories may differ from estimates used to determine inventory valuation allowances due to changes in customer demand, technology changes and other factors.

Table of Contents

Impairment of Long-lived Assets

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

Income Taxes

Our income taxes are computed using the asset and liability method of accounting. Under the asset and liability method, a deferred tax asset or liability is recognized for estimated future tax effects attributable to temporary differences and carryforwards. The measurement of deferred income tax assets is adjusted by a valuation allowance, if necessary, to recognize future tax benefits only to the extent, based on available evidence, it is more likely than not such benefits will be realized. Our deferred tax assets were fully reserved at March 31, 2005 and December 31, 2004.

For U.S. federal income tax purposes, at December 31, 2004, we had a net operating loss carryforward of approximately \$174.9 million, including operating loss carryforwards of Transilica and an unused research and development credit carryforward of approximately \$4.5 million, that will begin to expire in 2011. A change in ownership, as defined in Section 382 of the Internal Revenue Code, may limit utilization of the U.S. federal net operating loss and research and development credit carryforwards.

Commitments and Contingencies

We are subject to the possibility of loss contingencies for various legal matters. Our discussion of legal matters includes pending litigation and matters in which any party has manifested a present intention to commence litigation related to such matters. There can be no assurance that additional contingencies of a legal nature or having legal aspects will not be asserted in the future. Such matters could relate to prior transactions or events or future transactions and events. See Note 7 to our Unaudited Consolidated Financial Statements. We regularly evaluate current information available to us to determine whether any provisions for loss should be made. If we ultimately determine that a provision for loss should be made for a legal matter, the provision for loss could have a material and adverse effect on our operating results and financial position.

Our future cash commitments are primarily for long-term facility leases. In April 2005, we extended our operating lease for office space in Plano, Texas an additional 10 years with certain rights of early termination, reducing the monthly base rent and providing a leasehold improvement allowance. Our lease in Germany for our administrative, sales and marketing and research and development facility has an option to purchase the facility during certain time periods during the lease. The lease has a twenty-two year term, which began in December 1999.

Results of Operations

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

Edgar Filing: MICROTUNE INC - Form 10-Q

| | Three Months Ended March 31, | |
|--|---------------------------------|-------|
| | 2005 | 2004 |
| Net revenue | 100% | 100% |
| Cost of revenue | 48 | 54 |
| Gross margin | 52 | 46 |
| Operating expenses: | | |
| Research and development: | | |
| Stock option compensation | | 2 |
| Other | 33 | 30 |
| | 33 | 32 |
| Selling, general and administrative: | | |
| Stock option compensation | | 1 |
| Other | 34 | 74 |
| | 34 | 75 |
| Restructuring costs | | 1 |
| Amortization of intangible assets and goodwill | 5 | 10 |
| Total operating expenses | 72 | 118 |
| Loss from operations | (20) | (72) |
| Other income (expense) | 4 | (6) |
| Loss before provision for income taxes | (16) | (78) |
| Income tax expense | | 1 |
| Net loss | (16)% | (79)% |

Table of Contents

Comparison of the Three Months Ended March 31, 2005 and 2004

Net Revenue

Total net revenue for the first quarter of 2005 was \$12.2 million, compared to \$11.0 million for the first quarter of 2004, representing an increase of 10%. The increase for the first quarter of 2005 when compared to the same period of 2004 is due to increased sales of approximately \$1.9 million in the broadband communications market relating primarily to silicon tuner shipments into cable set-top box applications partially offset by a decrease in digital TV module shipments. The increase for the first quarter of 2005 when compared to same period of 2004 is also partially offset by decreased sales of approximately \$0.6 million in the transportation electronics market. In the first quarter of 2005 and 2004, revenue relating to shipments made in prior periods was \$0.1 million and \$0.2 million, respectively.

Sales to Scientific-Atlanta and Asuspower for the benefit of ARRIS and Terayon accounted for approximately 26% and 11%, respectively, of consolidated net revenue for the first quarter of 2005. Sales to DaimlerChrysler and Panasonic accounted for approximately 11% and 10%, respectively, of consolidated net revenue for the first quarter of 2004. We recognized 6% of our net revenue upon receipt of payment from our customers for the first quarter of 2005.

During the first quarter of 2004, the DaimlerChrysler subsidiary to which we sold AM/FM tuner modules was purchased by a competitor. Our final shipments to DaimlerChrylser occurred during the fourth quarter of 2004.

Sales to our ten largest customers, including sales to their respective manufacturing subcontractors, accounted for approximately 72% and 62% of our net revenue for the first quarter of 2005 and 2004, respectively.

Cost of Revenue

Cost of revenue includes the cost of subcontracted materials, integrated circuit assembly, final test, factory labor and overhead, shipping of materials, customs expenses, warranty costs and inventory charges. We also report costs for the depreciation of our test and handling equipment and logistics in cost of revenues. Our cost of revenue may increase due to price fluctuations and cyclical demand which we may not be able to pass on to our customers.

Cost of revenue as a percentage of net revenue was 48% and 54% for the first quarter of 2005 and 2004, respectively. The decrease in cost of revenue for the first quarter of 2005 when compared to the first quarter of 2004 is primarily the result of increased sales of our silicon-based products as a percentage of total sales, which have a lower cost of revenue than the mix of products sold in the first quarter of 2004, and fewer inventory-related charges in the first quarter of 2005 as compared to the first quarter of 2004, which included \$0.4 million in various inventory-related liabilities with a subcontractor. Our cost of revenue for the first quarter of 2005 and 2004 did not include approximately \$0.2 million and \$0.5 million, respectively, of costs relating to the sale of inventory which had previously been written-off as excess.

Research and Development

Edgar Filing: MICROTUNE INC - Form 10-Q

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

Research and development expenses, including non-cash stock compensation, for the first quarter of 2005 and 2004 were \$4.0 million, or 33% of net revenue, and \$3.6 million, or 32% of net revenue, respectively. The increase in research and development expenses is due primarily to an increase in development projects and related prototyping expenses for new silicon products. Stock option compensation related to research and development was insignificant for the first quarter of 2005 and \$0.2 million for the first quarter of 2004.

Selling, General and Administrative

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

Table of Contents

Selling, general and administrative expenses, including non-cash stock compensation, for the first quarter of 2005 and 2004 were \$4.1 million, or 33% of net revenue, and \$8.3 million, or 75% of net revenue, respectively. The decrease for the first quarter of 2005 as compared to the first quarter of 2004 was primarily due to an approximate \$3.0 million decrease in legal expenses in the first quarter of 2005 as compared to the first quarter of 2004 due to the settlement of our intellectual property litigation in June 2004, decreased activity in our ongoing SEC investigation, decreased activity in our shareholder and derivative lawsuits, and a \$0.3 million reimbursement of legal expenses from our insurance carriers. See Part II Item 1, *Legal Proceedings*. Our directors' and officers' liability insurance also decreased approximately \$0.9 million for the first quarter of 2005 as compared to the first quarter of 2004 as a result of a reduced annual premium effective September 2004. Stock option compensation related to selling, general and administrative was insignificant for the first quarter of 2005 and \$0.1 million for the first quarter of 2004.

Amortization of Intangible Assets

Amortization of intangible assets for the first quarter of 2005 and 2004 was \$0.7 million and \$1.1 million, respectively. Amortization of intangible assets in the first quarter of 2005 results principally from our acquired patents and will be nearly fully amortized by the fourth quarter of 2005.

Restructuring Costs

We incurred no restructuring costs for the first quarter of 2005. Restructuring costs for the first quarter of 2004 were \$0.1 million relating primarily to the closure of our San Diego design center during the fourth quarter of 2003. All restructuring efforts were completed in 2004 and we currently expect no restructuring costs in 2005.

Other Income and Expense

Other income consists of interest income from investment of cash and cash equivalents, foreign currency gains and losses and other non-operating income and expenses.

Interest income for the first quarter of 2005 and 2004 was \$0.5 million and \$0.2 million, respectively. The increase in interest income is mainly due to our higher cash and cash equivalents and investment balances and increased interest rates for the first quarter of 2005 as compared to the first quarter of 2004.

Our functional currency is the U.S. Dollar. The impact from the remeasurement of accounts not denominated in U.S. Dollars is recognized currently in our results of operations as a component of foreign currency gains and losses. Foreign currency losses, net were \$0.1 million and \$1.2 million for the first quarter of 2005 and 2004, respectively, resulting primarily from exchange rate fluctuations between the U.S. Dollar and the Euro.

Income Taxes

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

For U.S. federal income tax purposes, at December 31, 2004, we had net operating loss carryforwards of approximately \$174.9 million and an unused research and development credit carryforward of approximately \$4.5 million. These carryforwards begin to expire in 2011.

The provision for taxes during first quarter of 2005 and 2004 consists of foreign income taxes.

Liquidity and Capital Resources

As of March 31, 2005, we had net working capital of \$80.5 million, including \$12.6 million of cash and cash equivalents. We had \$62.0 million and \$3.6 million of short-term and long-term investments, respectively. At December 31, 2004, we had working capital, cash and cash equivalents, short-term investments and long-term investments of \$83.3 million, \$34.5 million, \$44.5 million and \$3.6 million, respectively. We consider highly liquid investments with original maturities of three months or less to be cash equivalents. We generally consider investments with maturities greater than three months but less than twelve months to be short term. In addition, auction-rate securities in established markets, which are available to support current operations, are recorded as short term due to their liquidity although their contractual maturities are greater than 10 years. We consider other investments with maturities greater than twelve months to be long term. Cash and cash equivalents consist of bank deposits and money market funds. Our investments, which consist of corporate debt securities and other securities issued by U.S. government and state agencies, including

Table of Contents

auction-rate securities, are comprised of high-quality securities in accordance with our investment policy. The carrying value of our investments approximates their fair values. Our investments are reviewed periodically for other-than-temporary impairment. In the aggregate, our cash, cash equivalents and short-term and long-term investments declined by approximately \$4.5 million during the first quarter of 2005 as a result of our continued operating losses and a \$2.0 million payment for a multi-year licensing agreement for engineering design and simulation software entered into in the normal course of business during the fourth quarter of 2004.

Operating activities used \$4.2 million in cash during the first quarter of 2005 compared to \$8.2 million for the first quarter of 2004. This decrease was primarily due to lower operating losses for the first quarter of 2005 as compared to the first quarter of 2004. Our accounts receivable days sales outstanding were 46 at March 31, 2005 compared to 41 at March 31, 2004.

Investing activities used \$17.7 million in cash during the first quarter of 2005 compared to generating \$9.2 million during the first quarter of 2004. The primary use of funds in the first quarter of 2005 was the purchase of \$25.0 million of available-for-sale investments offset by the sale of \$7.5 million of available-for-sale investments to achieve more favorable interest rates. The primary source of funds in the first quarter of 2004 was the sale of \$9.0 million of available-for-sale investments.

Financing activities provided \$0.1 million and \$0.3 million in cash during the first quarter of 2005 and 2004, respectively, consisting primarily of cash receipts from the exercise of employee stock options.

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

Future Operating Commitments

In the normal course of business, we may enter into leases for new or expanded facilities in both domestic and foreign locations. In April 2005, we extended our operating lease for office space in Plano, Texas an additional 10 years with certain rights of early termination, reducing the monthly base rent and providing a leasehold improvement allowance. We also evaluate, on an ongoing basis, the merits of acquiring technology or businesses, or establishing strategic relationships with and investing in other companies. We may decide to use cash and cash equivalents and short-term investments to fund such activities in the future.

Our future cash commitments are primarily for long-term facility leases. Future minimum lease payments required under operating leases as of March 31, 2005 and including the April 2005 lease extension for office space in Plano, Texas, are as follows (in thousands):

| <u>Year Ending December 31,</u> | |
|---------------------------------|--------|
| 2005 | \$ 829 |
| 2006 | 1,077 |
| 2007 | 879 |
| 2008 | 873 |

Edgar Filing: MICROTUNE INC - Form 10-Q

| | |
|------------|-----------|
| 2009 | 880 |
| Thereafter | 7,761 |
| | <hr/> |
| | \$ 12,299 |
| | <hr/> |

Other Commitments

We are currently subject to "line down" clauses in some contracts with our customers. Such clauses require us to pay financial penalties if our failure to supply product in a timely manner causes the customer to slow down or stop their production. We are also subject to product liability clauses and/or intellectual property indemnification clauses in some of our customer contracts. Such clauses require us to pay financial penalties if we supply defective product, which results in financial damages to the customer, or to indemnify the customer for third party actions based on infringement by our product of other's intellectual property. As of March 31, 2005, we are unaware of any such claims by any of our customers.

Purchase Commitments

As of April 22, 2005, we had approximately \$13.7 million of cancelable and non-cancelable purchase commitments outstanding with our vendors. These commitments were entered into in the normal course of business.

Table of Contents

FACTORS AFFECTING FUTURE OPERATING RESULTS AND STOCK PRICE

Our success depends on the growth of the consumer electronics/broadband communications market generally and the RF product market specifically.

We derive a substantial portion of our revenue from sales of RF products into markets related to consumer electronics/broadband communications applications. These markets are characterized by:

intense competition;

rapid technological change; and

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

Although the consumer electronics/broadband communications market has grown in the past, it may not grow in the future or a significant market slowdown may occur. Further, the market segments we serve, in particular the cable set-top box, cable modem, cable telephony, digital TV, PC-TV, and handheld TV markets may not grow at a rate sufficient for us to achieve and sustain profitability. Because of the intense competition in the consumer electronics/broadband communications market, the unproven technology of many products addressing the market and the short life cycles of many consumer products, it is difficult to predict the potential size and future growth rate of the overall RF product market. In addition, the consumer electronics/broadband communications market is transitioning from analog to digital, as well as expanding to new services, such as interactive television; handheld television and on-demand services. The future growth of the RF product market is partially dependent upon the market acceptance of products and technologies addressing the consumer electronics/broadband communications market, and there is no assurance that the RF technologies upon which our products are based will be accepted by any of these markets. If the demand for RF products is not as great as we expect, we may not be able to generate sufficient revenue to become successful.

We face intense competition in the consumer electronics/broadband communications and RF tuner markets, which could reduce our market share in existing markets and affect our ability to enter new markets.

The markets we compete in are intensely competitive. This competition has resulted and may continue to result in declining average selling prices for our RF products. We expect competition to continue to increase as industry standards become well known and as other competitors enter our target markets. We compete with, or may in the future compete with, a number of major domestic and international suppliers of integrated circuit and system modules in the cable modem, PC/TV, set-top box, cable telephony, handheld TV, digital TV and transportation markets. We compete primarily with tuner module manufacturers such as Alps, Philips Electronics, Samsung, and Thomson, with semiconductor companies such as Analog Devices, Broadcom, Freescale, LSI Logic, Maxim, Philips Semiconductors, RFMagic, ST Microelectronics, Texas Instruments, Xceive and Zarlink and potentially with new start-up companies. Broadcom, in particular, is shipping a silicon tuner product that competes with our tuner products in the broadband cable markets. Several of our competitors have broader product and service offerings and could bundle their competitive tuner products with their other products and services.

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

longer operating histories and presence in key markets;

greater name recognition;

access to larger customer bases;

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

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

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

As a result, our competitors may be able to adapt more quickly to new or emerging technologies and changes in customer requirements and may be able to devote greater resources to the development, promotion and sale of their products.

Industry participants may consolidate, impacting our ability to compete in our markets.

Consolidation by industry participants, including, in some cases, acquisitions of some of our customers, suppliers or partners by our competitors, or acquisitions of our competitors by our customers, suppliers or partners, could create entities with increased market share, customer base, technology and marketing expertise in markets in which we compete. Some of our suppliers or partners offer or may offer products that compete with our RF products. Depending on the participants, industry consolidation could significantly and

Table of Contents

adversely affect our current markets, the markets we are seeking to serve and our ability to compete successfully in those markets, thereby harming our results of operations. During the first quarter of 2004, the DaimlerChrysler subsidiary to which we sell AM/FM tuner modules was purchased by a competitor. Our final shipments to DaimlerChrysler occurred during the fourth quarter of 2004.

If we do not anticipate and adapt to evolving industry standards in the RF tuner and consumer electronics/broadband communications markets, or if industry standards develop more slowly than expected, our products could become obsolete and we could lose market share.

Products for consumer electronics/broadband communications applications often are based on industry standards that are continuously evolving. We have often directed our development toward producing RF products that comply with the evolving standards. In some cases, the development of these standards takes longer than originally anticipated. The delayed development of a standard in our target markets has and could result in slower deployment of new technologies, which can harm our ability to sell our RF products, or frustrate the continued use of our proprietary technologies, due to the anticipation of the deployment of a standard. The continued delay in the development of these industry standards could result in fewer manufacturers purchasing our RF products in favor of continuing to use the proprietary technologies designed by our competitors. Such delayed development of industry standards and the resulting slower deployment of new technologies would result in diminished and/or delayed revenue and consequently harm our business. Further, if new industry standards emerge, our products or our customers' products could become unmarketable or obsolete.

Our ability to adapt to changes and to anticipate future standards and the rate of adoption and acceptance of those standards is a significant factor in maintaining or improving our competitive position and prospects for growth. Our inability to anticipate the evolving standards in the consumer electronics/broadband communications market and, in particular, in the RF market, or to develop and introduce new products successfully into these markets, could result in diminished revenue and, consequently, harm our business. In addition, we may incur substantial unanticipated costs to comply with these evolving standards.

Other solutions for the consumer electronics/broadband communications market compete with some of our solutions. If these technologies prove to be more reliable, faster, less expensive or more popular, the demand for our RF products and our revenue may decrease.

Some of our target market segments, such as cable modem and cable telephony services, are competing with a variety of non-RF based broadband communications solutions, including digital subscriber line (DSL) technology. Many of these technologies compete effectively with cable modem and cable telephony services. If any of these competing technologies are more reliable, faster, less expensive, reach more customers or have other advantages over RF broadband technology, the demand for our RF products and, as a result, our revenue may decrease.

Our research and development efforts are critical to our business and may not be successful. Our future operating results may be negatively affected as a result.

Any future success will depend, in large part, upon our ability to develop new RF products for existing and new markets, including handheld TV; our ability to introduce these products in a cost-effective and timely manner; and our ability to meet customer specifications and convince leading manufacturers to select these products for design into their new products. The development of new RF products is highly complex and, from time to time, we have experienced delays in completing the development and introduction of new products. In addition, some of our new product development efforts are focused on producing silicon products utilizing architectures and technologies with which we have little or no experience, and delivering performance characteristics, such as low power consumption, at levels that we have not previously achieved. Under

some circumstances, we have failed. For example, our Bluetooth products never gained wide market acceptance.

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

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

We rely on a combination of patents, trademarks, copyrights, trade secret laws, confidentiality agreements and procedures and licensing arrangements to protect our intellectual property rights. We currently have patents issued and pending in the U.S. and in foreign countries. We intend to seek further U.S and international patents on our technology. We cannot be certain that patents will be issued from any of our pending applications, that patents will be issued in all countries where our products can be sold or that any claims will be allowed from pending applications or will be of sufficient scope or strength to provide meaningful protection or any commercial advantage. Our competitors also may be able to design around our patents. The laws of some countries in which our

Table of Contents

products are or may be developed, manufactured or sold, including various countries in Asia, may not protect our products or intellectual property rights to the same extent, as do the laws of the U.S., increasing the possibility of piracy of our technology and products. Although we intend to defend vigorously our intellectual property rights, we may not be able to prevent misappropriation of our technology. Our competitors may also independently develop technologies that are substantially equivalent or superior to our technology.

Despite our efforts and procedures to protect our intellectual property through the prosecution of patents, trademarks, copyrights and trade secrets and other methods, we cannot be assured that our current intellectual property or any intellectual property we may acquire through acquisitions or by other means will be free from third party claims which may be valid. In connection with recent acquisitions, including the Transilica acquisition, we conducted due diligence investigations of the intellectual property of these acquired companies for the purpose of assessing their protection efforts on their respective intellectual property. We cannot be assured that our investigatory efforts uncovered all or any defects related to the protection of intellectual property we acquired. As a result, intellectual property we acquire, including the intellectual property we acquired in the Transilica acquisition or in other acquisitions, may not be free from third party claims. Any third party claims may lead to costly and time-consuming litigation, which could harm our business and financial position.

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

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

ceasing the sale of our products that practice the asserted intellectual property of third parties;

obtaining from the owner of the infringed intellectual property right a license to sell or use the relevant technology, which license may not be available on commercially reasonable terms, if at all; or

redesigning those products that infringe intellectual property of third parties.

As a result, the expense associated with intellectual property litigation, management's and engineering staff's diversion from daily operation of our business caused by such litigation, and any legal limitation placed upon our products and/or our business related to such litigation may have a material and negative impact on our business and our financial results.

Furthermore, we have initiated, and may initiate in the future, claims or litigation against third parties for infringement of our proprietary rights or to establish their validity. Even if we successfully assert our intellectual property against a competitor in litigation, our patents may be attacked through a USPTO re-examination, which cannot be settled by the mutual agreement of the parties. For example, despite the settlement of all of our outstanding patent litigation with a competitor in the second quarter of 2004, we must continue to prosecute the validity of our '035 patent in the re-examination proceedings initiated by that competitor. If we are unsuccessful in such claims, others will be able to compete directly against us, which would materially, adversely affect our ability to sell our products and grow our business. Any current or future litigation by or against us, or one of our customers, could result in significant expense and divert the efforts of our technical personnel and management, whether or not the litigation results in a favorable determination.

Our ability to sell our RF products may suffer if any third party claims that we or our customers infringe on their intellectual property are determined to be valid, or if any of our issued patents are proven to be invalid.

The electronics industry is characterized by vigorous protection and pursuit of intellectual property rights and positions, which have resulted in significant and often protracted and expensive litigation. In addition, our customers may be subject to infringement claims for products incorporating our RF products. If any claims of infringement are made against any of our customers, our customers may seek to involve us in the infringement claim and request indemnification from us. If the claim resulted in an adverse result for our customer, it may reduce or completely eliminate marketing of its infringing product, which would decrease sales of our RF products to this customer. Further, if our customer prevailed in its claim for indemnification against us, or if we were found to infringe on any other third-party intellectual property, we could be required to:

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

indemnify our customers for their legal fees and damages paid;

stop manufacturing, using and selling the infringing products;

expend significant resources to develop non-infringing technology;

Table of Contents

discontinue the use of some of our processes; or

obtain licenses to the technology.

We may be unsuccessful in developing non-infringing products or negotiating licenses upon commercially reasonable terms. These problems might not be resolved in time to avoid harming our results of operations or may never be resolved.

Our customers' products are subject to governmental regulation.

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

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

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

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

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

If we are unable to continue to sell existing and new products to our key customers in significant quantities, or to attract new significant customers, our future operating results could be harmed.

We may not be able to maintain or increase sales to our key customers or to attract new significant customers for a variety of reasons, including the following:

most of our customers typically buy our RF products through a purchase order, rather than a supply agreement, which does not require them to purchase a minimum amount of our RF products;

most of our customers can stop purchasing our RF products with limited notice to us without incurring any significant contractual penalty;

many of our customers and potential customers have pre-existing relationships with our current or potential competitors, which may affect their decision to purchase our RF products;

some of our customers or potential customers offer or may offer products that compete with our RF products;

our longstanding relationships with some of our larger customers may also deter other potential customers who compete with these customers from buying our RF products;

some of our customers or potential customers may limit their purchases from us unless a second wafer manufacturing source is developed; and

Table of Contents

many of our competitors are larger than us and have greater financial resources.

If we do not maintain or increase sales to existing customers and attract significant new customers, our revenue would diminish and consequently our business would be harmed.

Because we depend on a few significant customers for a substantial portion of our revenue, the loss of a key customer could seriously harm our business.

We have derived a substantial portion of our revenue from sales to a relatively small number of customers. As a result, the loss of any significant customer could significantly harm our revenue. Sales to Scientific-Atlanta and Asuspower for the benefit of ARRIS and Terayon accounted for approximately 26% and 11%, respectively, of consolidated net revenue for the first quarter of 2005. Sales to DaimlerChrysler and Panasonic accounted for approximately 11% and 10%, respectively, of consolidated net revenue for the first quarter of 2004. Sales to our ten largest customers, including sales to their respective manufacturing subcontractors, accounted for approximately 72% and 62% of our net revenue for the first quarter of 2005 and 2004, respectively. We believe that our future operating results will continue to depend on the success of our largest customers and on our ability to sell existing and new products to these customers in significant quantities. The loss of a key customer or a reduction in our sales to any key customer could harm our revenue and consequently our financial condition. During the first quarter of 2004, the DaimlerChrysler subsidiary to which we sell AM/FM tuner modules was purchased by a competitor. Our final shipments to DaimlerChrysler occurred during the fourth quarter of 2004.

Uncertainties involving customer orders and shipment of our RF products could harm our business.

Our sales are typically made pursuant to individual purchase orders, and we generally do not have long-term supply arrangements with our customers, including our most significant customers, in terms of volume of sales. Our terms and conditions typically provide that our customers may cancel orders scheduled to ship outside 90 days. Further, terms typically provide that customers may reschedule orders that are scheduled to ship outside 30 days, but customers typically are restricted to the number of days they can push out the ship date. However, we have permitted customers to cancel orders less than 90 days before the expected date of shipment and to re-schedule shipments less than 30 days before the expected date of shipment, with little or no penalty.

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

As part of our routine business, we extend credit to our customers and invoice them for goods. At March 31, 2005, approximately 62% of our net accounts receivable were due from five of our customers. While customers may have the ability to pay on the date of shipment, or we believe customers have the ability to pay on the date credit is granted, their financial condition could change and there is no guarantee that customers will ever pay the invoices.

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

If we are unable to migrate our customers over time from our subsystem modules using discrete components to our RF silicon products or our subsystem modules that incorporate our RF silicon products, our operating results could be harmed.

Our future success will depend on our ability to continue the successful migration of our customers from our subsystem modules that use discrete components to our RF silicon products, or to subsystem modules containing our silicon products, by convincing leading equipment manufacturers to select these products for design into their own products. If we are not able to convince these manufacturers to incorporate our silicon products or modules containing our silicon products, our operating results could be harmed.

If we are unable to maintain certain purchase volumes from our subsystem module subcontractor, the cost of our subsystem module products could substantially increase and our operating results could be harmed.

The cost of our subsystem module products are directly affected by various factors, including our purchase volumes from our subsystem module subcontractor. If we are successful in migrating our customers over time from our subsystem modules to our RF silicon products, our purchase volumes of subsystem module products could decrease. If we are not able to negotiate favorable pricing in spite of potential volume decreases or attract new or existing customers to our subsystem module solutions, the cost of our subsystem module products could increase and our operating results could be harmed.

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

Historically, the average selling price of our products has decreased over their lives. In addition, as the markets for RF integrated circuit and module products mature, we believe that it is likely that the average unit prices of our RF products will decrease

Table of Contents

in response to competitive pricing pressures, increased sales discounts, new product introductions, competitive product bundling and a transition in our markets from higher priced module products to lower priced integrated circuits. To offset these decreases, we primarily rely on achieving cost reductions for materials used in existing products and on introducing new products that can often be sold at higher average selling prices or manufactured with lower costs.

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

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

Net revenue from outside of North America was 56% and 62% for the first quarter of 2005 and 2004, respectively. We plan to increase our international sales activities by adding international sales personnel, sales representatives or distributors. Our international sales will be limited if we cannot do so. Even if we are able to expand our international operations, we may not succeed in maintaining or increasing international market demand for our products.

We rely on business partners that could acquire, merge with or be acquired by our competitors which would limit our ability to deliver competitive products to our customers.

We rely upon some of our business partners for certain joint reference design and marketing activities. In addition, some of our products are incorporated in some of our business partners' reference designs that are provided to potential customers. In the event that one of our business partners acquired one of our competitors or was acquired by one of our competitors, our business could be harmed.

Product recall by a major customer could damage our business.

We generally warrant our commercial products for a period of one year, and longer for transportation electronics products. If a customer experiences a problem with our products and subsequently returns our products to us in large quantities for rework, replacement, or refund, the cost to us could be significant and severely impact our financial results.

Some of our customers require us to sign line down clauses, liability clauses and/or noninfringement clauses.

We are currently subject to line down clauses in some contracts with our customers. Such clauses require us to pay financial penalties if our failure to supply product in a timely manner causes the customer to slow down or stop their production. Such a penalty could be large and, if incurred, could severely harm our financial results. We are also subject to product liability clauses and/or intellectual property indemnification clauses in some of our customer contracts. Such clauses require us to pay financial penalties if we supply defective product, which results in financial damages to the customer, or to indemnify the customer for third party actions based on infringement by our product of other's intellectual property. Such a penalty could be large and, if incurred, could severely harm our financial results.

We expect our quarterly operating results to fluctuate.

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

timing, cancellation and rescheduling of significant customer orders, which result in revenue variability from one quarter to another;

the ability of our customers to procure the necessary components for their end-products that utilize our RF tuners to conduct their operations as planned for any quarter;

pricing concessions on volume sales to particular customers for established time frames;

slowdowns in customer demand and related industry-wide increases in inventories;

our inability to predict our customers' demand for our products;

changes in our product and customer mix between quarters;

labor disputes at our subcontractors manufacturing facility in the Philippines or at any of our other subcontractors, which may cause temporary slowdowns or shutdowns of operations;

quality problems with our products that result in significant returns;

inadequate allocation of wafer capacity for our silicon products and/or allocation of components used in our module products;

Table of Contents

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

Acts of God; force majeure.

Currency fluctuations related to our international operations could harm our financial results.

A significant portion of our international revenue and expenses are denominated in foreign currencies and we have experienced significant fluctuations in our financial results due to changing exchange rates rather than operational changes. For example, we recognized a foreign currency exchange loss of approximately \$0.1 million in the first quarter of 2005. We expect currency fluctuations to continue, and such fluctuations may significantly impact our financial results in the future. We may choose to engage in currency hedging activities to reduce these fluctuations, which may or may not prove to be successful.

Our cash reserves may prove insufficient to sustain our business. Additionally, there is no guarantee our insurance coverages, including our directors and officers liability insurance, are sufficient to protect us, or that we will be able to obtain such insurance in the future.

Currently, our expenses exceed our cash receipts, and we expect this trend to continue. Although there can be no assurance, we believe that our current balances of cash and cash equivalents and investments will provide adequate liquidity to fund our operations for the foreseeable future. Additionally, directors and officers liability insurance may not be available to us in sufficient amounts to cover any claims made or defense costs incurred if securities litigation is filed against us in the future. We also purchase various insurance policies to cover specifically designated risks in varying amounts. There is no guarantee that when a claim arises under any of the covered risks that our coverage will be sufficient to cover the entire claim or that any specific claim will be covered, even in part, by insurance. Also, there can be no guarantee that we will be able to obtain insurance in the future. These factors may result in rapid and substantial depletion of our cash reserves, and this depletion may result in our inability to properly operate our business.

We may be unable to obtain the capital required to grow our business.

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

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

Edgar Filing: MICROTUNE INC - Form 10-Q

The majority of our subsystem module solutions manufacturing operations are subcontracted to TFS. Such operations are conducted at a single facility in Manila, Philippines, which TFS has announced it intends to sell. If TFS is unable to sell the Manila facility, we will be required to move to an alternative manufacturing facility operated by TFS or engage a new subcontractor. The disruption caused by seeking and moving the manufacture of our products to an alternate facility or subcontractor could result in delays in our ability to deliver products to our customers, customer loss, and customer enforcement of contractual line down clauses subjecting us to high litigation costs and settlement payments, which would have a material negative impact on our business operations and our financial results. Additionally, there is no guarantee that a new manufacturing facility or subcontractor will supply products at the same cost as TFS Manila facility, which would have a negative impact on our financial results.

If TFS is successful in selling its Manila facility or if we move the manufacture of our products to an alternate facility or subcontractor, we would still be exposed to manufacturing risks as a result of our dependence on a single manufacturing facility and a single sub-contractor for our subsystem module solutions. Such risks include labor disputes, terrorism, political unrest, war, process abnormalities, human error, theft, government intervention, or a natural disaster such as a fire, earthquake, or flood. If we encounter any significant delays or disruptions, including those caused by our subcontractor's inability to procure component parts or supply us with product, we may not be able to meet our manufacturing and testing requirements, which could cause a significant delay in our ability to deliver our products, resulting in customer loss and customer enforcement of contractual line down clauses subjecting us to high litigation costs and settlement payments. Additionally, our subcontractor could elect to close its production facility or require us to move to another production facility or subcontractor. Any resulting delay could result in increased expense and costs and could have a negative impact on our business operations and our financial results.

Table of Contents

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

We do not own or operate a semiconductor fabrication facility. We primarily rely on IBM and X-FAB, outside subcontractors, to produce most of our integrated circuit RF products. We do not have a long-term supply agreement with our subcontractors and instead obtain manufacturing services on a purchase order basis. Our subcontractors have no obligation to supply products to us for any specific period, in any specific quantity or at any specific price, except as set forth in a particular purchase order. Our requirements represent a small portion of the total production capacity of these subcontractors, and they may reallocate capacity to other customers even during periods of high demand for our integrated circuits. If our subcontractors were to become unable or unwilling to continue manufacturing our integrated circuits, our business would be seriously harmed. As a result, we would have to identify and qualify substitute subcontractors, which would be time consuming and difficult, resulting in unforeseen manufacturing and operations problems. In addition, if competition for foundry capacity increases, our product costs may increase, and we may be required to pay significant amounts to secure access to manufacturing services. If we do not qualify or receive supplies from additional subcontractors, we may be exposed to increased risk of capacity shortages due to our dependence on IBM and X-FAB. In addition, the processing of our integrated circuit products are specific to the manufacturing processes of one or the other of our two suppliers and substantial lead-time would be required to move the specific product to the other supplier, if it were possible at all. Further, our customers may limit their purchases from us unless a second manufacturing source is developed, which could impact our sales.

We depend on third-party subcontractors for integrated circuit probe, packaging and testing, which reduces our control over the integrated circuit packaging process and testing and could increase costs and decrease availability of our integrated circuit products.

Our integrated circuit products are probed, packaged, and/or tested by independent subcontractors, including Amkor, ASE, ISE and BridgePoint, using facilities located in South Korea, Philippines, and Austin, Texas. We do not have long-term agreements with these subcontractors and typically obtain services from them on a purchase order basis. Our reliance on these subcontractors involves risks such as reduced control over delivery schedules, quality assurance and costs. Our reliance on BridgePoint involves additional risk due to its current bankruptcy proceedings. These risks could result in product shortages or increase our costs of packaging our products. If these subcontractors are unable or unwilling to continue to provide packaging and testing services of acceptable quality, at acceptable costs and in a timely manner, our business would be seriously harmed. We would also have to identify and qualify substitute subcontractors, which could be time consuming and difficult and may result in unforeseen operations problems.

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

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

Our Quality Certifications are subject to periodic re-evaluation.

Our Germany design facility is currently ISO-9000:2000 and ISO-14001 certified. These certifications and others are subject to recertification on a periodic basis. The transfer of our module manufacturing to the control of TFS could have adverse consequences on our ability to obtain future certifications.

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

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

Table of Contents

Uncertainties in our production planning process could harm our business.

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

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

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

Our international operations, including our operations in Germany, Taiwan, Japan and Korea, as well as our international suppliers operations, as well as our overall financial results, may be negatively affected by actions taken or events that occur in these countries or around the world.

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

Our success could be jeopardized by loss of personnel, particularly key personnel, and our inability to attract qualified candidates.

Any success we may have in the future will depend largely upon the continued service of our personnel, particularly our key personnel and executive management. Our success also will depend on our ability to attract, retain and motivate qualified personnel. We rely heavily upon equity compensation incentives; specifically, we grant options to purchase our common stock to attract, retain and motivate our personnel. The equity incentives of our competitors and other elements of our competitors' compensation structures, particularly cash compensation, may be significantly more attractive than the compensation packages we offer.

Edgar Filing: MICROTUNE INC - Form 10-Q

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

The competition for attracting qualified candidates is intense, particularly so in the RF silicon and RF system industries. Our ability to attract qualified candidates is essential to any success we may have in the future. Due to the reasons above, our ability to attract, retain and motivate qualified technical, management, and other candidates necessary for the design, development, manufacture and sale of our RF products may be impaired, perhaps significantly.

Table of Contents

Provisions in our charter documents, Delaware law and our rights plan may deter takeover efforts and, in part, impact our stock price.

Several provisions of our amended and restated certificate of incorporation, amended and restated bylaws and stockholder rights plan may discourage, delay or prevent a merger or acquisition that you may consider favorable and therefore may harm the stock price. Those provisions include:

authorizing the issuance of blank check preferred stock;

providing for a classified board of directors with staggered, three-year terms;

prohibiting cumulative voting in the election of directors;

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

prohibiting stockholder action by written consent;

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

establishing super-majority voting requirements in some instances; and

providing rights to purchase fractional shares of preferred stock to our existing stockholders in the event of an acquisition attempt.

Pursuant to our Proxy Statement filed on April 27, 2005, our board of directors has recommended that our stockholders approve certain amendments to our amended and restated certificate of incorporation and amended and restated bylaws that, if approved, would have the effect of declassifying our board of directors.

We have been the target of several securities fraud class action complaints and are at risk of future securities class action litigation. Future litigation could result in substantial costs to us, drain our resources and divert our management's attention.

Initial Public Offering Litigation

Starting on July 11, 2001, multiple purported securities fraud class action complaints were filed in the United States District Court for the Southern District of New York. We are aware of at least three such complaints: *Berger v. Goldman, Sachs & Co., Inc. et al.*; *Atlas v. Microtune et al.*; and *Ellis Investments Ltd. v. Goldman, Sachs & Co., Inc. et al.* The complaints are brought purportedly on behalf of all persons who purchased our common stock from August 4, 2000 through December 6, 2000 and are related to *In re Initial Public Offering Securities*

Edgar Filing: MICROTUNE INC - Form 10-Q

Litigation (IPO cases). The Atlas complaint names as defendants Microtune; Douglas J. Bartek, our former Chairman and Chief Executive Officer; Everett Rogers, our former Chief Financial Officer and Vice President of Finance and Administration; and several investment banking firms that served as underwriters of our initial public offering. Microtune, Mr. Bartek and Mr. Rogers were served with notice of the Atlas complaint on August 22, 2001, however, they have not been served regarding the other referenced complaints. The Berger and Ellis Investment Ltd. complaints assert claims against the underwriters only. The complaints were consolidated and amended on May 29, 2002. The amended complaint alleges liability under §§ 11 and 15 of the Securities Act of 1933, as amended (1933 Act Claims) and §§ 10(b) and 20(a) of the Securities Exchange Act of 1934, as amended (1934 Act Claims), on the grounds that the registration statement for our initial public offering did not disclose that (1) the underwriters had agreed to allow certain of their customers to purchase shares in the offering in exchange for excess commissions paid to the underwriters, and (2) the underwriters had arranged for certain of their customers to purchase additional shares in the aftermarket at pre-determined prices. The amended complaint also alleges that false analyst reports were issued. No specific amount of damages is claimed. We are aware that similar allegations have been made in other lawsuits filed in the Southern District of New York challenging over 300 other initial public offerings and secondary offerings conducted in 1998, 1999 and 2000. Those cases have been consolidated for pretrial purposes before the Honorable Shira A. Scheindlin. On February 19, 2003, the Court ruled on all defendants' motions to dismiss. The Court denied the motions to dismiss the 1933 Act Claims. The Court did not dismiss the 1934 Act Claims against us and other issuers and underwriters.

We have accepted a settlement proposal presented to all issuer defendants. Under the settlement, plaintiffs will dismiss and release all claims against the Microtune defendants. The insurance companies collectively responsible for insuring the issuer defendants in all of the IPO cases will guarantee plaintiffs a recovery of \$1 billion, an amount that covers all of the IPO cases. Under this guarantee, the insurers will pay the difference, if any, between \$1 billion and the amount collected by the plaintiffs from the underwriter defendants in all of the IPO cases. The Microtune defendants will not be required to pay any money in the settlement. However, any payment made by the insurers will be charged to the respective insurance policies covering each issuer's case on a *pro rata* basis (that is, the total insurance company payments will be divided by the number of cases that settle). If the *pro rata* charge exceeds the amount of insurance coverage for an issuer, that issuer would be responsible for additional payments. The proposal also provides that the insurers will pay for the company's legal fees going forward. The settlement will require approval of the Court, which cannot be assured.

Table of Contents

On February 15, 2005, the Court issued an order providing preliminary approval of the settlement except to the extent the settlement would have cut off contractual indemnification claims that underwriters may have against securities issuers, such as Microtune. The Court set a hearing to consider final approval of the settlement for January 9, 2006.

Class Action Litigation

Beginning in February 2003, Microtune, our former Chairman of the Board and Chief Executive Officer, Douglas J. Bartek, our former Chief Financial Officer and Vice-President of Finance and Administration, Everett Rogers, our former President and Chief Operating Officer, William L. Housley, and our former Chief Financial Officer and former General Counsel, Nancy A. Richardson, were named as defendants in several class action lawsuits filed in the United States District Court for the Eastern District of Texas. These suits allege violations of federal securities laws and regulations. The claims of the plaintiffs in the various lawsuits include that the defendants violated §§10(b) and 20(a) of the Securities Exchange Act of 1934, as amended, as well as SEC Rule 10b-5, resulting in damages to persons who purchased, converted, exchanged, or otherwise acquired our common stock between July 23, 2001 and February 20, 2003, inclusive. The plaintiffs' specific allegations include that the defendants engaged in fraudulent accounting and financial practices and misrepresented material facts and omitted to state material facts necessary to make other statements made not misleading, and that these misrepresentations or omissions had the effect of artificially inflating Microtune's stock price. The alleged misrepresentations and omissions include, among others, allegations that: Microtune materially overstated revenue by recognizing certain sales immediately as revenue when deferred revenue recognition would have been more appropriate; Microtune failed to establish reserves when appropriate; Microtune lacked adequate internal controls to assure its financial statements were fairly presented in conformity with generally accepted accounting principles; Microtune lacked sufficient controls and procedures for the timely and accurate issuance of periodic press releases; Microtune lacked sufficient means to monitor prior public statements to detect whether an update was required; and Microtune failed to record impairment charges relating to the assets acquired with the Transilica acquisition at the appropriate time.

On November 23, 2004, Microtune and the other defendants entered into a settlement agreement with the plaintiffs under which the defendants agreed to settle the consolidated lawsuit for \$5,625,000, inclusive of plaintiffs' attorneys' fees and costs, in return for a full release of all claims and dismissal of the consolidated lawsuit. On April 4, 2005, the district court entered an order of dismissal and final judgment which gave final approval to the securities class action litigation settlement. Microtune and the other defendants made no admission of wrongdoing as part of the settlement. The settlement is subject to appeal for thirty days from the date of final court approval.

Under a separate agreement with Microtune's director and officer insurance carriers, the insurance carriers have agreed to reimburse the settlement amount, subject to Microtune's 15% co-pay obligation. The settlement will not have a material impact on our business prospects, results of operations or financial condition. If the order of dismissal and final judgment is appealed, Microtune intends to vigorously defend the consolidated lawsuit.

Stockholder Derivative Litigation

Beginning on October 30, 2003, various stockholder derivative lawsuits were filed in the United States District Court for the Eastern District of Texas, against current and former officers and directors of Microtune. The derivative lawsuits were consolidated on January 5, 2004, and the consolidated suit was styled in re Microtune, Inc. Derivative Litigation, Master File No. 4:03CV409 (derivative litigation). The plaintiffs alleged various breaches of fiduciary duties, abuse of control, and waste of corporate assets against all the defendants for which they sought contribution and indemnification.

Edgar Filing: MICROTUNE INC - Form 10-Q

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

Under a separate agreement with Microtune's director and officer insurance carriers, the insurance carriers have agreed to reimburse the majority of the plaintiffs' attorneys' fees and expenses, subject to the Company's 15% co-pay obligation. The settlement will not have a material impact on our business prospects, results of operations or financial condition.

Table of Contents

Directors and Officers Liability Insurance

If our directors and officers liability insurance is insufficient or unavailable to cover the amount of any damages that may result from pending and future securities litigation for any reason, we may be required to pay the costs of indemnifying and defending certain of our directors and officers. Directors and officers liability insurance may not be available to us in sufficient amounts to cover any claims made in securities litigation filed against us in the future.

Securities and Exchange Commission Investigation

On August 4, 2003, we received written notification that Microtune is the subject of an investigation by the Securities and Exchange Commission (SEC). The SEC advised Microtune that the process under way is a fact-finding investigation. The investigation relates directly to the internal inquiry commissioned by the Audit Committee of our Board in 2003. We are cooperating fully with the SEC, and we have had discussions with the SEC regarding possible settlement of this matter.

Changes in the accounting treatment of stock options will adversely affect our results of operations.

In December 2004, the FASB issued SFAS No. 123R, *Share-Based Payment*. SFAS No. 123R is a revision of SFAS No. 123, *Accounting for Stock Based Compensation*, and supersedes APB 25. Among other items, SFAS 123R eliminates the use of APB 25 and the intrinsic value method of accounting, and requires companies to recognize the cost of employee services received in exchange for awards of equity instruments, based on the grant date fair value of those awards, in the financial statements. As recently amended, the effective date of SFAS 123R is the beginning of the first fiscal year beginning after June 15, 2005, which is first quarter 2006 for calendar year companies, although early adoption is allowed. This change in accounting treatment will materially and adversely affect our reported results of operations as the stock-based compensation expense will be charged directly against our reported earnings. For an illustration of the effect of such a change in our recent results of operations, see Note 1 to our Unaudited Consolidated Financial Statements.

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

Our ability to file the required reports in a timely manner with the Securities and Exchange Commission, including quarterly reports on Form 10-Q and annual reports on Form 10-K, could be impacted by the following events:

loss of key management or finance and accounting personnel;

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

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

Edgar Filing: MICROTUNE INC - Form 10-Q

unexpected change of our outside audit firm;

significant acquisitions or mergers;

disposition of a business segment; and

Acts of God; force majeure.

This could result in an adverse reaction in the financial marketplace due to a loss of investor confidence in the reliability of our financial statements, which ultimately could negatively impact the market price of our shares. Additionally, this could result in the delisting of our stock from the Nasdaq National Market and subsequent quoting of our stock on the pink sheets, hindering liquidity of our stock and increasing trading fees to investors.

Investor confidence and share value may be adversely impacted if we and our independent registered public accounting firm are unable to provide adequate attestation over the adequacy of our internal controls over financial reporting, as required by Section 404 of the Sarbanes-Oxley Act of 2002.

The Securities and Exchange Commission, as directed by Section 404 of the Sarbanes-Oxley Act of 2002, adopted rules requiring public companies to include a report of management on the company's internal controls over financial reporting in its annual reports on Form 10-K that contain an assessment by management of the effectiveness of the company's internal controls over financial reporting. In addition, the company's independent registered public accounting firm must attest to and report on management's assessment of the effectiveness of the company's internal controls over financial reporting. This requirement will continue to apply to our future Annual Reports on Form 10-K. Although we intend to diligently and vigorously review our internal controls over financial

Table of Contents

reporting in order to ensure compliance with the Section 404 requirements, there is no assurance that we will be successful in future years. Further, if our independent registered public accounting firm is not satisfied with our internal controls over financial reporting or the level at which these controls are documented, designed, operated or reviewed, or if the independent registered public accounting firm interprets the requirements, rules or regulations differently from us, then they may decline to attest to management's assessment or may issue a report that is qualified. This could result in an adverse reaction in the financial marketplace due to a loss of investor confidence in the reliability of our financial statements, which ultimately could negatively impact the market price of our shares.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

We are exposed to certain market risks in the ordinary course of our business. These risks result primarily from changes in foreign currency exchange rates and interest rates. In addition, our international operations are subject to risks related to differing economic conditions, differing tax structures, and other regulations and restrictions. More detailed information concerning market risk is contained in our 2004 Annual Report on Form 10-K.

Item 4. Controls and Procedures

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

Changes in Internal Control over Financial Reporting. There have been no changes in our internal control over financial reporting that occurred during the quarter ended March 31, 2005 that have materially affected or are reasonably likely to materially affect our internal control over financial reporting.

PART II .

Other Information

Item 1. Legal Proceedings

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

Table of Contents

Item 6. Exhibits

- 10.1⁽¹⁾ * Settlement and Release Agreement between St. Paul Mercury Insurance Company, Sheffield Insurance Company, Westchester Fire Insurance Company, Greenwich Insurance Company and Microtune, Inc., Douglas J. Bartek, William Housley, Everett Rogers, Nancy A. Richardson, James A. Fontaine, James H. Clardy, William P. Tai, Harvey B. Cash, Walter S. Ciciora, Steven Craddock and Anthony J. LeVecchio dated November 22, 2004.
- 10.2⁽¹⁾ Stipulation and Agreement of Settlement between Marc D. Reasoner, Fred B. Knadler, on behalf of Lights N Such, Inc., Warren and Betty Stewart and Microtune, Inc., Douglas J. Bartek, William Housley, Everett Rogers, and Nancy A. Richardson dated November 23, 2004.
- 10.3⁽¹⁾ * Supplemental Agreement to the Stipulation and Agreement of Settlement between Marc D. Reasoner, Fred B. Knadler, on behalf of Lights N Such, Inc., Warren and Betty Stewart and Microtune, Inc., Douglas J. Bartek, William Housley, Everett Rogers, and Nancy A. Richardson dated November 23, 2004.
- 10.4⁽¹⁾ * Addendum to Settlement and Release Agreement between St. Paul Mercury Insurance Company, Sheffield Insurance Company, Westchester Fire Insurance Company, Greenwich Insurance Company and Microtune, Inc., Douglas J. Bartek, William Housley, Everett Rogers, Nancy A. Richardson, James A. Fontaine, James H. Clardy, William P. Tai, Harvey B. Cash, Walter S. Ciciora, Steven Craddock and Anthony J. LeVecchio dated January 9, 2005.
- 10.5⁽¹⁾ Stipulation and Agreement of Settlement between Michael Blizman, Nathan Hostacky, Michael Morris, and Phung Vu and Microtune, Inc., James A. Fontaine, James H. Clardy, William P. Tai, Harvey B. Cash, Walter S. Ciciora, Steven Craddock, Anthony J. LeVecchio, Douglas J. Bartek, William Housley, Everett Rogers, and Nancy A. Richardson dated January 10, 2005.
- 10.6⁽¹⁾ Amendment No. 1 to the Custom Sales Agreement between International Business Machines Corporation and the Registrant dated January 13, 2005.
- 10.7⁽¹⁾ Change of Control Agreement between Phillip D. Peterson and the Registrant dated January 20, 2005.
- 10.8⁽¹⁾ Indemnification Agreement between Albert H. Taddiken and the Registrant dated February 10, 2005.
- 10.9⁽¹⁾ Indemnification Agreement between Robert S. Kirk and the Registrant dated February 10, 2005.
- 31.1 Certification of Chief Executive Officer under Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Principal Financial Officer under Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of Chief Executive Officer under Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certification of Principal Financial Officer under Section 906 of the Sarbanes-Oxley Act of 2002.

⁽¹⁾ Incorporated by reference to Registrant's Annual Report on Form 10-K for the year ended December 31, 2004 filed on March 11, 2005.

* Portions of this exhibit were omitted pursuant to a request for confidential treatment and filed separately.

Table of Contents

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.

Date: May 2, 2005

/s/ JAMES A. FONTAINE

James A. Fontaine

Chief Executive Officer