

UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

**FORM 10-Q**

(Mark One)

☒ QUARTERLY REPORT PURSUANT TO SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934  
For the quarterly period ended September 30, 2003.

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 **0-25236**

**MICREL, INCORPORATED**

(Exact name of Registrant as specified in its charter)

California  
(State or other jurisdiction of  
incorporation or organization)

94-2526744  
(I.R.S. Employer Identification No.)

2180 Fortune Drive, San Jose, CA 95131  
(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code: (408) 944-0800

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act. Yes ☒ No ☐

As of October 31, 2003 there were 92,147,819 shares of common stock, no par value, outstanding.

**MICREL, INCORPORATED**  
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**REPORT ON FORM 10-Q**  
**FOR THE THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2003**

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**ITEM 1. FINANCIAL STATEMENTS**

**MICREL, INCORPORATED**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**  
**(Unaudited)**  
(In thousands, except share amounts)

	<b>September 30, 2003</b>	<b>December 31, 2002 <sup>(1)</sup></b>
<b>ASSETS</b>		
<b>CURRENT ASSETS:</b>		
Cash and cash equivalents	\$ 126,772	\$ 117,363
Accounts receivable, net	32,206	29,577
Inventories	37,024	39,531
Other current assets	2,674	2,675
Deferred income taxes	<u>30,470</u>	<u>30,828</u>
Total current assets	229,146	219,974
PROPERTY, PLANT AND EQUIPMENT, NET	88,824	92,318
DEFERRED INCOME TAXES	4,966	9,606
INTANGIBLE ASSETS, NET	6,220	8,387
OTHER ASSETS	<u>444</u>	<u>390</u>
<b>TOTAL</b>	<b><u>\$ 329,600</u></b>	<b><u>\$ 330,675</u></b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>CURRENT LIABILITIES:</b>		
Accounts payable	\$ 11,367	\$ 13,026
Taxes payable	--	3,405
Deferred income on shipments to distributors	11,130	9,832
Other current liabilities	13,637	10,645
Current portion of long-term debt	<u>856</u>	<u>911</u>
Total current liabilities	36,990	37,819
LONG-TERM DEBT	10,303	10,983
OTHER LONG-TERM OBLIGATIONS	5,313	8,254
<b>SHAREHOLDERS' EQUITY:</b>		
Preferred stock, no par value - authorized: 5,000,000 shares; issued and outstanding: none	--	--
Common stock, no par value - authorized: 250,000,000 shares; issued and outstanding: 2003 - 92,233,819 shares; 2002 - 92,006,571 shares	158,443	160,889
Deferred stock compensation	(5,023)	(9,971)
Accumulated other comprehensive loss	(26)	(25)
Retained earnings	<u>123,600</u>	<u>122,726</u>
Total shareholders' equity	<u>276,994</u>	<u>273,619</u>
<b>TOTAL</b>	<b><u>\$ 329,600</u></b>	<b><u>\$ 330,675</u></b>

(1) Derived from the audited balance sheet included in the Annual Report on Form 10-K of Micrel, Incorporated for the year ended December 31, 2002.

See Notes to Condensed Consolidated Financial Statements.

**MICREL, INCORPORATED**

**CONDENSED CONSOLIDATED STATEMENT OF OPERATIONS**

(Unaudited)

(In thousands, except per share amounts)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2003	2002	2003	2002
NET REVENUES	\$ 53,364	\$ 50,367	\$ 153,428	\$ 154,055
COST OF REVENUES*	<u>32,160</u>	<u>37,110</u>	<u>93,451</u>	<u>101,926</u>
GROSS PROFIT	<u>21,204</u>	<u>13,257</u>	<u>59,977</u>	<u>52,129</u>
OPERATING EXPENSES:				
Research and development	11,500	14,104	36,325	40,475
Selling, general and administrative	7,263	7,940	20,837	24,809
Amortization of deferred stock compensation*	834	2,358	2,515	7,410
Manufacturing facility impairment	(624)	23,357	(624)	23,357
Restructuring expense	<u>286</u>	<u>5,536</u>	<u>286</u>	<u>5,536</u>
Total operating expenses	<u>19,259</u>	<u>53,295</u>	<u>59,339</u>	<u>101,587</u>
INCOME (LOSS) FROM OPERATIONS	1,945	(40,038)	638	(49,458)
OTHER INCOME, NET	<u>150</u>	<u>284</u>	<u>497</u>	<u>872</u>
INCOME (LOSS) BEFORE INCOME TAXES	2,095	(39,754)	1,135	(48,586)
PROVISION (BENEFIT) FOR INCOME TAXES	<u>482</u>	<u>(15,286)</u>	<u>261</u>	<u>(20,407)</u>
NET INCOME (LOSS)	<u>\$ 1,613</u>	<u>\$ (24,468)</u>	<u>\$ 874</u>	<u>\$ (28,179)</u>
NET INCOME (LOSS) PER SHARE:				
Basic	<u>\$ 0.02</u>	<u>\$ (0.26)</u>	<u>\$ 0.01</u>	<u>\$ (0.30)</u>
Diluted	<u>\$ 0.02</u>	<u>\$ (0.26)</u>	<u>\$ 0.01</u>	<u>\$ (0.30)</u>
SHARES USED IN COMPUTING PER SHARE AMOUNTS:				
Basic	<u>92,032</u>	<u>92,563</u>	<u>92,174</u>	<u>92,845</u>
Diluted	<u>93,735</u>	<u>92,563</u>	<u>93,317</u>	<u>92,845</u>
* Amortization of deferred stock compensation related to:				
Cost of revenues	<u>\$ 279</u>	<u>\$ 770</u>	<u>\$ 870</u>	<u>\$ 2,322</u>
Operating expenses:				
Research and development	\$ 462	\$ 1,199	\$ 1,471	\$ 3,926
Selling, general and administrative	<u>372</u>	<u>1,159</u>	<u>1,044</u>	<u>3,484</u>
Total operating expenses	<u>\$ 834</u>	<u>\$ 2,358</u>	<u>\$ 2,515</u>	<u>\$ 7,410</u>

See Notes to Condensed Consolidated Financial Statements.

**MICREL, INCORPORATED**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(Unaudited)

(In thousands)

	<b>Nine Months Ended September 30,</b>	
	<b>2003</b>	<b>2002</b>
<b>NET CASH FLOWS PROVIDED BY OPERATING ACTIVITIES:</b>		
Net income (loss)	\$ 874	\$ (28,179)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	22,046	25,961
Manufacturing facility impairment	(624)	23,357
Stock based compensation	3,385	9,732
Loss on disposal of assets	(3)	73
Deferred rent	19	(467)
Deferred income taxes	4,998	(18,193)
Changes in operating assets and liabilities:		
Accounts receivable	(2,629)	(4,363)
Inventories	2,507	(8,583)
Prepaid expenses and other assets	(53)	2,855
Accounts payable	(1,659)	872
Income taxes	(4,319)	--
Other accrued liabilities	32	5,367
Deferred income on shipments to distributors	1,298	(1,374)
Net cash provided by operating activities	<u>25,872</u>	<u>7,058</u>
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Purchases of property, plant and equipment	(15,758)	(27,042)
Purchase of intangible asset	--	(2,054)
Proceeds from sales and maturities of short-term investments	--	3,092
Net cash used by investing activities	<u>(15,758)</u>	<u>(26,004)</u>
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Proceeds from long-term debt borrowing	--	10,736
Repayments of long-term debt	(735)	(3,021)
Proceeds from the issuance of common stock	3,531	6,293
Repurchase of common stock	(3,501)	(26,440)
Net cash used by financing activities	<u>(705)</u>	<u>(12,432)</u>
<b>NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS</b>	<b>9,409</b>	<b>(31,378)</b>
<b>CASH AND CASH EQUIVALENTS - Beginning of period</b>	<b><u>117,363</u></b>	<b><u>130,406</u></b>
<b>CASH AND CASH EQUIVALENTS - End of period</b>	<b><u>\$ 126,772</u></b>	<b><u>\$ 99,028</u></b>
<b>SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:</b>		
Cash paid during the period for:		
Interest	<u>\$ 513</u>	<u>\$ 286</u>
Income taxes	<u>\$ 661</u>	<u>\$ 91</u>
Non-cash transactions:		
Deferred stock compensation (reversal)	<u>\$ (1,562)</u>	<u>\$ (2,917)</u>
Acquisition of intangible asset under patent cross license and settlement agreement	<u>\$ --</u>	<u>\$ 5,154</u>

See Notes to Condensed Consolidated Financial Statements.

**MICREL, INCORPORATED**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**(Unaudited)**

**1. SIGNIFICANT ACCOUNTING POLICIES**

**Interim Financial Information** - The accompanying condensed consolidated financial statements of Micrel, Incorporated and its wholly-owned subsidiaries ("Micrel" or the "Company") as of September 30, 2003 and for the three and nine months ended September 30, 2003 and 2002 are unaudited. In the opinion of management, the condensed consolidated financial statements include all adjustments (consisting only of normal recurring accruals) that management considers necessary for a fair presentation of its financial position, operating results and cash flows for the interim periods presented. Operating results and cash flows for interim periods are not necessarily indicative of results for the entire year.

This financial data should be read in conjunction with the audited consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2002. This financial data should also be read in conjunction with the Company's critical accounting policies included in Management's Discussion and Analysis of Financial Condition and Results of Operations in the Company's Annual Report on Form 10-K for the year ended December 31, 2002.

**Net Income (Loss) Per Common and Equivalent Share** - Basic net income (loss) per share is computed by dividing net income (loss) by the number of weighted average common shares outstanding. Diluted net income (loss) per share reflects potential dilution from outstanding stock options using the treasury stock method. Reconciliation of weighted average shares used in computing earnings per share is as follows (in thousands):

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2003</b>	<b>2002</b>	<b>2003</b>	<b>2002</b>
Weighted average common shares outstanding	92,032	92,563	92,174	92,845
Dilutive effect of stock options outstanding using the treasury stock method	1,343	--	1,143	--
Shares used in computing diluted net income (loss) per share	<u>93,375</u>	<u>92,563</u>	<u>93,317</u>	<u>92,845</u>

For the three and nine months ended September 30, 2002, 1.5 million and 3.2 million common stock equivalent shares, respectively, have been excluded from the weighted-average number of common shares outstanding for the diluted net loss per share computations as they were anti-dilutive.

**Stock Based Awards** - The Company accounts for stock-based awards to employees using the intrinsic value method in accordance with Accounting Principles Board Opinion ("APB") No. 25, "Accounting for Stock Issued to Employees". Deferred stock compensation balances are recorded as a contra-equity amount and amortized as a charge to operating results over the applicable vesting periods. As of September 30, 2003 total unamortized stock compensation was \$5.0 million.

SFAS No. 123, "Accounting for Stock-Based Compensation," requires the disclosure of pro forma net income and earnings per share had the Company applied the fair value method. Under SFAS 123, the fair value of stock-based awards to employees is calculated through the use of option pricing models, even though such models were developed to estimate the fair value of freely tradable, fully transferable options without vesting restrictions, which significantly differ from the Company's stock option awards. These models also require subjective assumptions, including future stock volatility and expected time to exercise, which greatly affect the calculated values. The Company's calculations for the fair value of stock options were made using the Black-Scholes option pricing model with the following weighted average assumptions for 2003 and 2002, respectively: expected life, 60 months; stock volatility, 85% and 86%; risk free interest rates, 3%; and no dividends during the expected terms. The Company's calculations are based on a multiple option valuation approach and forfeitures are recognized as they occur. The Company's calculations for the fair value of stock issued under the employee stock purchase plan were made using the Black-Scholes option pricing model with

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the following weighted average assumptions for 2003 and 2002, respectively: expected life, 6 months; stock volatility, 85% and 86%; risk free interest rates 1%; and no dividends during the term.

SFAS No. 148 amends SFAS No. 123 in December 2002 to require that disclosures of the pro forma effect of using the fair value method of accounting for stock-based employee compensation be displayed more prominently and in a tabular format. The following table illustrates the effect on the Company's net income (loss) and net income (loss) per share if it had recorded compensation costs based on the estimated grant date fair value as defined by SFAS No. 123 for all granted stock-based awards (in thousands, except per share amounts):

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2003</b>	<b>2002</b>	<b>2003</b>	<b>2002</b>
Net income (loss) as reported	\$ 1,613	\$ (24,468)	\$ 874	\$ (28,179)
Add: stock-based employee compensation expense included in reported net income (loss), net of tax effects	677	1,902	2,058	5,917
Deduct: stock-based employee compensation expense determined under fair value based method, net of tax effects	(3,394)	(3,722)	(10,244)	(16,105)
Pro forma net loss	<u>\$ (1,105)</u>	<u>\$ (26,288)</u>	<u>\$ (7,312)</u>	<u>\$ (38,367)</u>
Net income (loss) per share as reported:				
Basic	<u>\$ 0.02</u>	<u>\$ (0.26)</u>	<u>\$ 0.01</u>	<u>\$ (0.30)</u>
Diluted	<u>\$ 0.02</u>	<u>\$ (0.26)</u>	<u>\$ 0.01</u>	<u>\$ (0.30)</u>
Pro forma net loss per share:				
Basic	<u>\$ (0.01)</u>	<u>\$ (0.28)</u>	<u>\$ (0.08)</u>	<u>\$ (0.41)</u>
Diluted	<u>\$ (0.01)</u>	<u>\$ (0.28)</u>	<u>\$ (0.08)</u>	<u>\$ (0.41)</u>

## 2. RECENTLY ISSUED ACCOUNTING STANDARDS

In January 2003, the Financial Accounting Standards Board ("FASB" or the "Board") issued Interpretation No. 46 ("FIN 46") "Consolidation of Variable Interest Entities." FIN 46 requires certain variable interest entities to be consolidated by the primary beneficiary of the entity if the equity investors in the entity do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. FIN 46 is effective immediately for all new variable interest entities created or acquired after January 31, 2003. For variable interest entities created or acquired before February 1, 2003, the provisions of FIN 46 must be applied for the first interim or annual period beginning after December 15, 2003. The Company does not currently anticipate this statement to have any effect on its financial statements.

In November 2002, the Emerging Issues Task Force reached a consensus on Issue No. 00-21 ("EITF 00-21"), "Revenue Arrangements with Multiple Deliverables." EITF 00-21 provides guidance on how to account for arrangements that involve the delivery or performance of multiple products, services and/or rights to use assets. The provisions of EITF 00-21 will apply to revenue arrangements entered into in fiscal periods beginning after June 15, 2003. The adoption of this standard had no material impact on the Company's financial statements.

In May 2003, the FASB issued Statement of Accounting Standards No. 150 ("SFAS 150"), "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity." SFAS No. 150 changes the accounting guidance for certain financial instruments that, under previously guidance, could be classified as equity or "mezzanine" equity by now requiring those instruments to be classified as liabilities (or assets in

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**(Unaudited)**

some circumstances) in the statement of financial position. Further, SFAS No. 150 requires disclosure regarding the terms of those instruments and settlement alternatives. SFAS No. 150 is generally effective for all financial instruments entered into or modified after May 31, 2003, and is otherwise effective at the beginning of the first interim period beginning after June 15, 2003. While the effective date of certain elements of SFAS No. 150 have been deferred, the adoption of SFAS No. 150 when finalized is not expected to have a material impact on the Company's financial position, results of operations or cash flows.

**3. INVENTORIES**

Inventories consist of the following (in thousands):

	<b>September 30, 2003</b>	<b>December 31, 2002</b>
Finished goods	\$ 13,133	\$ 15,597
Work in process	22,783	22,523
Raw materials	1,108	1,411
	<u>\$ 37,024</u>	<u>\$ 39,531</u>

**4. BORROWING ARRANGEMENTS**

Borrowing agreements consisted of \$5.0 million revolving line of credit from a commercial bank. There were no borrowings under the revolving line of credit agreement at September 30, 2003. The revolving line of credit agreement expires on June 30, 2005. Borrowings under the revolving line of credit bear interest rates of, at the Company's election, the prime rate (4.0% at September 30, 2003), or the bank's revolving offshore rate, which approximates LIBOR (1.16% at September 30, 2003) plus 2.0%. The agreement contains certain restrictive covenants that include a restriction on the declaration and payment of dividends without the lender's consent. The Company was in compliance with all such covenants at September 30, 2003.

In September 2002, associated with the purchase of its previously leased manufacturing facilities in San Jose, CA, the Company borrowed \$10.7 million through a commercial mortgage financing agreement. Borrowings under this agreement bear interest, at the Company's election, at the daily floating prime rate (4.0% at September 30, 2003), or adjustable monthly LIBOR (1.16% at September 30, 2003) plus 1.5%. The principal balance of the loan shall be repaid in 59 consecutive monthly installments of \$16,890 and one final installment in the amount necessary to pay in full the remaining outstanding principal balance. The mortgage agreement contains certain restrictive covenants. The Company was in compliance with all such covenants at September 30, 2003.

As of September 30, 2003, the Company had \$11.2 million under term notes outstanding.

**5. SIGNIFICANT CUSTOMERS**

During the nine months ended September 30, 2003, two customers, a world-wide distributor and an Asian based stocking representative, accounted for \$19.4 million (13%) and \$17.9 million (12%) of net revenues, respectively. No direct original equipment manufacturer accounted for more than 10% of net revenues. During the nine months ended September 30, 2002, one customer, an Asian based stocking representative, accounted for \$19.9 million (13%) of net revenues. No direct original equipment manufacturer accounted for more than 10% of net revenues.



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**(Unaudited)**

**6. COMPREHENSIVE INCOME (LOSS)**

Comprehensive income or loss, which was comprised of the Company's net income or loss for the periods and changes in unrealized gains or losses on investments, was net income of \$1.6 million and \$874,000 for the three and nine months ended September 30, 2003, respectively, and net loss of \$24.5 million and \$28.2 million for the three and nine months ended September 30, 2002, respectively.

**7. SEGMENT REPORTING**

The Company follows the provisions of SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information. SFAS No. 131 establishes standards for reporting information regarding operating segments in annual financial statements and requires selected information for those segments to be presented in interim financial reports issued to stockholders. SFAS No. 131 also establishes standards for related disclosures about products and services and geographic areas. Operating segments are identified as components of an enterprise about which separate discrete financial information is available for evaluation by the chief operating decision maker. The Company operates in two reportable segments: standard products and custom and foundry products. The chief operating decision maker evaluates segment performance based on revenue. Accordingly, all expenses are considered corporate level activities and are not allocated to segments. Therefore, it is not practical to show profit or loss by operating segments. Also, the chief operating decision maker does not assign assets to these segments. Consequently, it is not practical to show assets by operating segments.

**Net Revenues by Segment**  
**(Dollars in thousands)**

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2003</b>	<b>2002</b>	<b>2003</b>	<b>2002</b>
<b>Net Revenues:</b>				
Standard Products	\$ 48,182	\$ 42,811	\$ 137,016	\$ 135,219
Custom and Foundry Products	5,182	7,556	16,412	18,836
Total net revenues	<u>\$ 53,364</u>	<u>\$ 50,367</u>	<u>\$ 153,428</u>	<u>\$ 154,055</u>
<b>As a Percentage of Total Net Revenues:</b>				
Standard Products	90%	85%	89%	88%
Custom and Foundry Products	10%	15%	11%	12%
Total net revenues	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>

**8. LITIGATION AND OTHER CONTINGENCIES**

On February 26, 1999, the Lemelson Medical, Education & Research Foundation (the "Lemelson Partnership") filed a complaint which was served on the Company on June 15, 1999, entitled Lemelson Medical, Education & Research Foundation, Limited Partnership v. Lucent Technologies Inc., et al. in the United States District Court in Phoenix, Arizona, against eighty-eight defendants, including the Company, alleging infringement of Lemelson Foundation patents. The complaint in the lawsuit seeks unspecified compensatory damages, treble damages and attorneys' fees, as well as injunctive relief against further infringement of the Lemelson patents at issue. The case is currently in the motion and hearing phase. The Company intends to continue to defend itself against these claims.

On May 9, 1994, Linear Technology Corporation ("Linear" or "LTC"), a competitor of the Company, filed a complaint against the Company, entitled Linear Technology Corporation v. Micrel, Incorporated, in the

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**(Unaudited)**

United States District Court in San Jose, California, alleging patent and copyright infringement and unfair competition. All claims, except the patent infringement claim, have been settled or dismissed. The complaint in the lawsuit seeks unspecified compensatory damages, treble damages and attorneys' fees as well as preliminary and permanent injunctive relief against infringement of the Linear patent at issue. On August 20, 1999, the United States District Court in San Jose adjudicated in favor of the Company on a motion, finding the patent to be invalid under the "on sale bar" defense as the plaintiff had placed integrated circuits containing the alleged invention on sale more than a year before filing its patent application. The United States District Court in San Jose dismissed the plaintiff's complaint on the merits of the case and awarded the Company its legal costs. Linear appealed the trial Court's decision to the United States Court of Appeal for the Federal Circuit ("CAFC") on September 17, 1999. On December 28, 2001 the CAFC reversed the District Court's judgment of invalidity and remanded the case to the District Court. After the Company's Petition for Rehearing En Banc by the Court of Appeal was denied, the Company filed a Petition for Writ of Certiorari with the Supreme Court of the United States, which Linear opposed. On May 19, 2003, the Supreme Court denied the Petition for Writ of Certiorari. The parties subsequently attended a case management conference with the District Court, at which time a schedule was determined for further discovery and hearing matters before the Court. The Company intends to continue to defend itself against the claims alleged in this litigation.

On December 27, 2002, the Company filed a complaint against TRW, Inc. ("TRW") entitled Micrel, Incorporated v. TRW, Inc., dba TRW Automotive Electronics Group, in the United States District Court, Northern District of Ohio, Eastern Division, alleging various causes of action relating to breach of a relationship surrounding the development of certain custom products by Micrel for TRW. In this lawsuit, Micrel is alleging that TRW breached various agreements to assist in Micrel's development of, and to purchase, certain Application Specific Integrated Circuits. The complaint seeks compensatory damages, attorneys' fees and costs of suit. On February 24, 2003, TRW filed an answer to the Company's complaint and a counterclaim alleging various causes of action relating to breach of the above-mentioned relationship concerning ASIC development. The case is currently in the motion and discovery phase.

On April 21, 2003, the Company filed a complaint against its former principal accountants Deloitte & Touche LLP ("Deloitte") entitled Micrel, Incorporated v. Deloitte & Touche LLP in the Superior Court of the State of California, County of Santa Clara, alleging various causes of action relating to certain professional advice received by Micrel from Deloitte. In this lawsuit, Micrel is alleging that Deloitte negligently rendered services as accountants to Micrel, breached certain agreements with Micrel by failing to perform services using ordinary skill and competence and in conformance with generally accepted principles for such work and made certain false representations upon which Micrel justifiably relied. As a direct result of Deloitte's actions, Micrel alleges damages including: expenses incurred in the form of payments to various professionals to address the impact on Micrel's financial statements and other effects of the wrongful conduct; loss of cash as well as equity from stock options; additional charges to earnings that Micrel would not incur but for the wrongful advice; additional potential liability for taxes; potential liability for tax penalties; and the harm to Micrel in both financial and semiconductor markets resulting in loss of overall value of the company as a whole. The complaint seeks compensatory damages, costs of suit and such other relief that the court may deem just and proper. The case is currently in the discovery phase.

The Company believes that the ultimate outcome of the legal actions discussed above will not result in a material adverse effect on the Company's financial condition, results of operation or cash flows. However, litigation is subject to inherent uncertainties, and no assurance can be given that the Company will prevail in these lawsuits. Accordingly, the pending lawsuits, as well as potential future litigation with other companies, could result in substantial costs and diversion of resources and could have a material adverse effect on the Company's financial condition, results of operations or cash flows.

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**(Unaudited)**

The semiconductor industry is characterized by recurrent litigation regarding patent and other intellectual property rights. To the extent that the Company becomes involved in such intellectual property litigation, it could result in substantial costs and diversion of resources to the Company and could have a material adverse effect on the Company's financial condition, results of operation or cash flows.

In the event of an adverse ruling in any intellectual property litigation that now exists or might arise in the future, the Company might be required to discontinue the use of certain processes, cease the manufacture, use and sale of infringing products, expend significant resources to develop non-infringing technology or obtain licenses to the infringing technology. There can be no assurance, however, that under such circumstances, a license would be available under reasonable terms or at all. In the event of a successful claim against the Company and the Company's failure to develop or license substitute technology on commercially reasonable terms, the Company's financial condition, results of operations, or cash flows could be adversely affected.

Certain additional claims and lawsuits have arisen against the Company in its normal course of business. The Company believes that these claims and lawsuits will not have a material adverse effect on the Company's financial condition, results of operation or cash flows.

**9. STOCK REPURCHASE PROGRAM**

In February 2002, the Company's Board of Directors announced a stock repurchase program under which the Company could purchase up to \$20.0 million of its common stock. In July 2002, the Board of Directors approved the repurchase of additional stock up to a value of \$20.0 million, thereby increasing the total authorized stock repurchase to \$40.0 million of common stock in 2002. In February 2003, the Board of Directors extended the authorization to repurchase shares of common stock through December 31, 2003, up to a maximum purchase amount of \$40 million for the years 2002 and 2003. In August 2003, the Board of Directors extended the authorization to repurchase shares of common stock through March 31, 2004, up to a maximum purchase amount of \$45 million for the time period commencing February 11, 2002, of which \$12.4 million remains authorized for repurchases through March 31, 2004. Shares of common stock purchased pursuant to the repurchase program are cancelled upon repurchase, and are intended to offset dilution from the Company's stock option plans, employee stock purchase plans and 401(k). The Company repurchased 297,900 shares of its common stock for \$3.5 million during the nine months ended September 30, 2003.

**10. STOCK OPTION EXCHANGE PROGRAM**

On November 8, 2002 the Company filed a Schedule TO with the Securities and Exchange Commission in order to initiate an offer to its employees to exchange certain of their outstanding options for new options to be granted six months and two days after expiration of the exchange offer. The Company's Directors, CEO and CFO were not eligible to participate in the stock option exchange program. This offer to exchange contemplated a grant of new options to eligible employees in a ratio equivalent to one new option granted for every two options elected for exchange and cancelled with respect to employees who held at the time of the offer the position of vice president or higher, and two new options granted for every three options elected for exchange and cancelled with respect to all other employees. The only options eligible to be exchanged were those outstanding employee stock options with an exercise price of \$13 or higher.

On December 11, 2002, options to purchase 3,330,401 shares of the Company's common stock were surrendered, and were replaced on June 13, 2003 with options to purchase 1,901,769 shares at an exercise price of \$10.72 equal to the closing sales price of the Company's common stock as quoted on the Nasdaq National Market on the date preceding the replacement grant date.

**MICREL, INCORPORATED**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**(Unaudited)**

**11. RESTRUCTURING AND MANUFACTURING FACILITY IMPAIRMENT**

In September 2002, the Company approved a plan to close its Santa Clara, CA wafer fabrication facility to reduce costs and improve operating efficiencies. Associated with the facility closure, the Company accrued \$5.5 million in restructuring expenses which consisted of \$1.0 million for equipment disposal costs and \$4.5 million in net contractual building lease costs, excluding estimated sublease income, that will provide no future benefit. During July 2003, the Company ceased all manufacturing processes within the Santa Clara facility and completed the relocation of all employees to its San Jose, CA facilities.

Associated with the wafer fabrication facility closure, during the quarter ended September 30, 2003, the Company incurred and paid severance costs of \$320,000 related to the termination of 46 employees, which consisted primarily of wafer fabrication operators and maintenance technicians. These termination costs have been reported as restructuring expense in the statement of operations.

During the quarter ended September 30, 2003, the Company revised its estimates related to severance costs, contractual facility costs and equipment disposal costs based upon activity to date and estimated future costs. A summary of restructuring expense accrual is as follows: (\$000)

	<u>Severance Costs</u>	<u>Contractual Facility Costs</u>	<u>Equipment Disposal</u>	<u>Total</u>
2002 Charges	\$ --	\$ 4,536	\$ 1,000	\$ 5,536
Uses	<u>--</u>	<u>--</u>	<u>--</u>	<u>--</u>
Balance December 31, 2002	\$ --	\$ 4,536	\$ 1,000	\$ 5,536
2003 Charges	320	466	(500)	286
Uses	<u>(320)</u>	<u>(466)</u>	<u>(48)</u>	<u>(834)</u>
Balance September 30, 2003	<u>\$ --</u>	<u>\$ 4,536</u>	<u>\$ 452</u>	<u>\$ 4,988</u>

Of the \$5.0 million in accrued restructuring costs, \$2.1 million has been classified as other current liabilities and the remaining \$2.9 million has been classified as other long-term obligations as of September 30, 2003. These restructuring costs are expected to be paid in cash over the remaining facility lease term, which expires in October 2006.

Also related to the facility closure, in September 2002, the Company recorded a \$23.4 million impairment of long-lived assets to reduce the net book value of the facility's leasehold improvements and equipment to fair value. The fair value was based on a third party estimate of the current net sales value. In August 2003, the company sold previously impaired equipment which resulted in a \$624,000 gain, recognized as an adjustment to manufacturing facility impairment expense for the three and nine month periods ending September 30, 2003.

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

### **Overview**

Micrel designs, develops, manufactures and markets a range of high performance standard analog integrated circuits and high-speed mixed-signal and digital integrated circuits. These circuits are used in a wide variety of electronics products, including those in the computer, telecommunications, industrial and networking markets. In addition to standard products, the Company manufactures custom analog and mixed-signal circuits and provides wafer foundry services.

The Company derives a substantial portion of its net revenues from standard products. Standard products sales represented 90% and 89% of net revenues for the three and nine months ended September 30, 2003, respectively, as compared to 85% and 88% for the similar periods in the prior year. The Company believes that a substantial portion of its net revenues in the future will depend upon standard products sales, although such sales as a proportion of net revenues may vary as the Company adjusts product output levels to correspond with varying economic conditions and demand levels in the markets which it serves. The standard products business is characterized by short-term orders and shipment schedules, and customer orders typically can be canceled or rescheduled without significant penalty to the customer. Since most standard products backlog is cancelable without significant penalty, the Company typically plans its production and inventory levels based on internal forecasts of customer demand, which is highly unpredictable and can fluctuate substantially. In addition, the Company is limited in its ability to reduce costs quickly in response to any revenue shortfalls.

The Company may experience significant fluctuations in its results of operations. Factors that affect the Company's results of operations include the volume and timing of orders received, changes in the mix of products sold, the utilization level of manufacturing capacity, competitive pricing pressures and the successful development of new products. These and other factors are described in further detail later in this discussion. As a result of the foregoing or other factors, there can be no assurance that the Company will not experience material fluctuations in future operating results on a quarterly or annual basis, which could materially and adversely affect the Company's business, financial condition, results of operations or cash flows.

### **Critical Accounting Policies**

The financial statements included in this Form 10-Q and discussed within this Management's Discussion and Analysis of Financial Condition and Results of Operations have been prepared in accordance with accounting principles generally accepted in the United States. Preparation of these financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. On an on-going basis, management evaluates its estimates and judgements. Management bases its estimates and judgements on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. For a detailed discussion of the Company's significant accounting policies, see Note 1 of Notes to Consolidated Financial Statements in Item 14 of the Company's Annual Report on Form 10-K for the year ended December 31, 2002.

*Revenue Recognition.* Micrel generates revenue by selling products to original equipment manufacturers ("OEM"s), distributors and stocking representatives. Stocking representative firms may buy and stock the Company's products for resale or may act as the Company's sales representative in arranging for direct sales from the Company to an OEM customer. The Company's policy is to recognize revenue from sales to customers when the rights and risks of ownership have passed to the customer, when persuasive evidence of an arrangement exists, the product has been delivered, the price is fixed and determinable and collection of the resulting receivable is reasonably assured.

## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

Micrel allows certain distributors, primarily located in North America and Europe, significant return rights and pricing adjustments subsequent to the initial product shipment. Micrel defers recognition of revenue and related cost of sales (in the balance sheet line item "deferred income on shipments to distributors") derived from sales to these distributors until they have resold the Company's products to their customers. Sales to OEM customers and stocking representatives, primarily located in Asia, which have limited return rights and pricing adjustments, are recognized upon shipment and a related returns allowance is established based upon historical return rates. Actual future returns could be different than the returns allowance established. The Company also maintains an allowance for doubtful accounts for estimated uncollectible accounts receivables. This estimate is based on an analysis of specific customer creditworthiness and historical bad debts experience. Actual future uncollectible amounts could exceed the doubtful accounts allowance established.

*Inventory Valuation.* Inventories are stated at the lower of cost (first-in, first-out method) or market. The Company has taken adjustments to write-down the cost of obsolete and excess inventory to the estimated market value based on historical and forecasted demand for its products. If actual future demand for the Company's products is less than currently forecasted, additional inventory adjustments may be required. Once a reserve is established, it is maintained until the product to which it relates is sold or otherwise disposed of. This treatment is in accordance with Accounting Research Bulletin 43 and Staff Accounting Bulletin 100 "Restructuring and Impairment Charges."

*Income Taxes.* Resulting primarily from temporary timing differences between book and tax valuation of assets and liabilities, state and federal research and development credit carryforwards and state manufacturers credit carryforwards, the Company had net deferred tax assets of \$35.4 million as of September 30, 2003, as compared to \$40.4 million as of December 31, 2002. The reduction in deferred assets resulted primarily from the reversal of temporary timing difference associated with the closure of the Company's Santa Clara, CA wafer fabrication facility. The Company believes that future taxable income levels will be sufficient to realize the tax benefits of these deferred tax assets and has not established a valuation allowance.

*Litigation.* The semiconductor industry is characterized by litigation regarding patent and other intellectual property rights. The Company is currently involved in such intellectual property litigation (see Note 8 of Notes to Condensed Consolidated Financial Statements) and has not accrued any liability for such litigation. The Company regularly evaluates current information available to determine whether such accruals should be made. An estimated liability would be accrued when it is determined to be probable that a liability has been incurred and the amount of loss can be reasonably estimated. If the Company were to determine that such a liability was probable and could be reasonably estimated, the adjustment would be charged to income in the period such determination was made.

### Results of Operations

The following table sets forth certain operating data as a percentage of total net revenues for the periods indicated:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2003	2002	2003	2002
Net revenues	100.0%	100.0%	100.0%	100.0%
Cost of revenues	60.3	73.7	60.9	66.2
Gross profit	39.7	26.3	39.1	33.8
Operating expenses:				
Research and development	21.6	28.0	23.7	26.3
Selling, general and administrative	13.6	15.7	13.6	16.1
Amortization of deferred stock compensation	1.6	4.7	1.6	4.8
Manufacturing facility impairment	(1.2)	46.4	(0.4)	15.1
Restructuring expense	0.5	11.0	0.2	3.6
Total operating expenses	36.1	105.8	38.7	65.9
Income (loss) from operations	3.6	(79.5)	0.4	(32.1)
Other income, net	0.3	0.6	0.3	0.6
Income (loss) before income taxes	3.9	(78.9)	0.7	(31.5)
Provision (benefit) for income taxes	0.9	(30.3)	0.1	(13.2)
Net income(loss)	3.0%	(48.6)%	0.6%	(18.3)%

## **MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)**

Net Revenues. For the three months ended September 30, 2003, net revenues increased 6% to \$53.4 million from \$50.4 million for the same period in the prior year, reflecting increased sales of standard products. For the nine months ended September 30, 2003, net revenues were relatively flat at \$153.4 million compared to \$154.1 million for the same period in the prior year, which resulted from increased sales of standard products which were offset by decreased sales of custom and foundry products.

For the three months ended September 30, 2003, standard products revenues increased 13% to \$48.2 million from \$42.8 million for the same period in the prior year. This increase resulted primarily from increased unit shipments of industrial, telecommunications, computer and communications products which was partially offset by decreased average selling prices across all significant standard product lines. For the nine months ended September 30, 2003, standard products revenues increased 1% to \$137.0 million from \$135.2 million for the same period in the prior year. This increase resulted primarily from increased unit shipments of industrial, telecommunications, computer and communications products, which was partially offset by decreased average selling prices across all significant standard product lines.

For the three months ended September 30, 2003, custom and foundry products revenues decreased 31% to \$5.2 million from \$7.6 million for the same period in the prior year. For the nine months ended September 30, 2003, custom and foundry products revenues decreased 13% to \$16.4 million compared to \$18.8 million for the same period in the prior year. These decreases resulted primarily from decreased average selling prices, which were partially offset by increased unit shipments.

Customer demand for semiconductors can change quickly and unexpectedly. As a result of the slowing global economy, a rapid build-up of semiconductor inventories in global sales channels occurred during 2001, causing lead times for components to fall precipitously. Although it is generally believed that industry wide channel inventories have decreased substantially since 2001, the short lead time environment has continued from the middle of 2001 through the end of the third quarter of 2003 as a result of underutilization of manufacturing capacity and relatively high levels of work-in-process inventories within the semiconductor industry. For over two years, customers have perceived that semiconductor components have been readily available and have ordered only for their short-term needs, resulting in historically low order backlog levels. The Company's revenue levels have been highly dependent on the amount of new orders that are received for which product is requested to be delivered to the customer within the same period. Within the semiconductor industry these orders that are booked and shipped within the period are called "turns fill" orders. During the three months ended September 30, 2003, 58% of the Company's shipments resulted from turns-fill orders as compared to 57% for the same period in the prior year. The Company believes the current high turns-fill requirements and pricing pressure will continue until lead times substantially increase and order backlogs grow. The Company experienced an increase in order rates and backlog in the third quarter of 2003, indicating that demand for semiconductors may be increasing and that customers may be becoming more concerned about product availability. However, the sustainability of improved customer demand is uncertain, and the high turns fill requirement together with, the uncertainty of product mix and pricing, make it difficult to predict future levels of sales and profitability and may require the Company to continue to carry higher levels of inventory, .

International sales represented 70% and 67% of net revenues for the quarters ended September 30, 2003 and 2002, respectively. On a dollar basis, international sales increased 10% to \$37.2 million for the quarter ended September 30, 2003 from \$33.9 million for the comparable period in 2002. This increase resulted primarily from increased unit shipments of telecommunications, computer and Ethernet communications products, primarily in Asia, which were partially offset by decreased average selling prices. For each of the nine months ended September 30, 2003 and 2002, international sales represented 69% of net revenues. On a dollar basis, international sales decreased 1% to \$105.3 million for the nine months ended September 30, 2003 from \$106.3 million for the comparable period in 2002. This decrease resulted primarily from decreased average selling prices, which were partially offset by increased unit shipments of telecommunications, computer Ethernet communications products.

## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

The Company's international sales are denominated in U.S. currency. Consequently, changes in exchange rates that strengthen the U.S. dollar could increase the price in local currencies of the Company's products in foreign markets and make the Company's products relatively more expensive than competitors' products that are denominated in local currencies, leading to a reduction in sales or profitability in those foreign markets. The Company has not taken any protective measures against exchange rate fluctuations, such as purchasing hedging instruments with respect to such fluctuations.

*Gross Profit.* Gross profit is affected by a variety of factors including the volume of product sales, product mix, manufacturing utilization, product yields and average selling prices. For the three months ended September 30, 2003 the Company's gross margin increased to 40% from 26% for the comparable period in 2002. For the nine months ended September 30, 2003 the Company's gross margin increased to 39% from 34% for the comparable period in 2002. These increases in gross margin resulted primarily from a \$4.5 million charge for excess inventory included in the 2002 results, combined with decreased wafer fabrication costs resulting from the Company's wafer fabrication consolidation project (see Note 11 of Notes to Condensed Consolidated Financial Statements), lower costs for external assembly and test manufacturing services and the shipment of approximately \$1.3 million in previously reserved inventory, which were partially offset by a reduction in average selling prices, as compared to the same periods in 2002. The Company believes pricing pressure will continue to affect gross profit until industry manufacturing capacity utilization levels increase and order lead times extend beyond current levels.

*Research and Development Expenses.* Research and development expenses include costs associated with the development of new processes and the definition, design and development of new products. The Company also expenses prototype wafers and new production mask sets related to new products as research and development costs until products based on new designs are fully characterized by the Company and are demonstrated to support published data sheets and satisfy reliability tests.

As a percentage of net revenues, research and development expenses represented 22% and 28% for the three months ended September 30, 2003 and 2002, respectively. On a dollar basis, research and development expenses decreased \$2.6 million or 18% to \$11.5 million for the three months ended September 30, 2003 from \$14.1 million for the comparable period in 2002. For the nine months ended September 30, 2003 and 2002, research and development expenses represented 24% and 26% of net revenues, respectively. On a dollar basis, research and development expenses decreased \$4.2 million or 11% to \$36.3 million for the nine months ended September 30, 2003 from \$40.5 million for the comparable period in 2002. The dollar decreases were primarily due to decreased prototype fabrication costs combined with reduced staffing costs. The Company believes that the development and introduction of new products is critical to its future success and expects to continue its investment in research and development activities in the future.

*Selling, General and Administrative Expenses.* As a percentage of net revenues, selling, general and administrative expenses represented 14% and 16% for the three months ended September 30, 2003 and 2002, respectively. On a dollar basis, selling, general and administrative expenses decreased \$677,000 or 9% to \$7.3 million for the three months ended September 30, 2003 from \$7.9 million for the comparable period in 2002. For the nine months ended September 30, 2003 and 2002, selling, general and administrative expenses represented 14% and 16% of net revenues, respectively. On a dollar basis, selling, general and administrative expenses decreased \$4.0 million or 16% to \$20.8 million for the nine months ended September 30, 2003 from \$24.8 million for the comparable period in 2002. The dollar decreases were principally attributable to decreased outside legal costs combined with decreased advertising expenses.



## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

*Amortization of deferred stock compensation.* The Company accounts for stock-based awards to employees using the intrinsic value method in accordance with Accounting Principles Board Opinion No. 25 ("APB 25"), "Accounting for Stock Issued to Employees". Certain Company practices in effect prior to January 2002 related to employee stock option pricing resulted in stock compensation expense under APB 25. For the three months ended September 30, 2003 total amortization of deferred stock compensation was \$1.1 million of which \$279,000 was included in cost of revenues and \$834,000 was included in amortization of deferred stock compensation. For the three months ended September 30, 2002 total amortization of deferred stock compensation was \$3.1 million of which \$770,000 was included in cost of revenues and \$2.4 million was included in amortization of deferred stock compensation. For the nine months ended September 30, 2003 total amortization of deferred stock compensation was \$3.4 million of which \$870,000 was included in cost of revenues and \$2.5 million was included in amortization of deferred stock compensation. For the nine months ended June 30, 2002 total amortization of deferred stock compensation was \$9.7 million of which \$2.3 million was included in cost of revenues and \$7.4 million was included in amortization of deferred stock compensation. The decreases in 2003 resulted primarily from accelerated recognition of stock compensation during the fourth quarter of 2002 associated with an employee stock option exchange program (see Note 10 of Notes to Condensed Consolidated Financial Statements). As of September 30, 2003 total unamortized stock compensation was \$5.0 million with remaining amortization of \$1.0 million in 2003, \$2.8 million in 2004, \$926,000 in 2005 and \$333,000 in 2006.

*Manufacturing Facility Impairment and Restructuring Expense.* In September 2002, the Company approved a plan to close its Santa Clara, CA wafer fabrication facility to reduce costs and improve operating efficiencies. Associated with the facility closure, the Company accrued \$5.5 million in restructuring expenses. During July 2003, the Company ceased all manufacturing processes within the Santa Clara facility and completed the relocation of all employees to its San Jose, CA facilities. During the three and nine months ended September 30, 2003, the Company paid \$834,000 in restructuring costs that reduced the previous restructuring accrual and recorded an additional \$286,000 in net restructuring accrual adjustments which were charged to restructuring expense in the three and nine months ended September 30, 2003 (see Note 11 of Notes to Condensed Consolidated Financial Statements).

Also related to the facility closure, in September 2002, the Company recorded a \$23.4 million impairment of long-lived assets to reduce the net book value of the facility's leasehold improvements and equipment to fair value. The fair value was based on a third party estimate of the current net sales value. During the three and nine months ended September 30, 2003, the company sold previously impaired equipment resulting in a \$624,000 gain which has been recorded as an adjustment to the manufacturing facility impairment expense.

*Other Income, Net.* Other income, net reflects interest income from investments in short-term, investment-grade, securities and money market funds offset by interest expense incurred on term notes, combined with other non-operating income or expenses. For the three months ended September 30, 2003, other income, net was \$150,000 compared to \$284,000 for the comparable period in 2002. The decrease was primarily due to decreased rates of return on cash, cash equivalents and short-term investments as compared to the prior year. For the nine months ended September 30, 2003, other income, net was \$497,000 compared to \$872,000 for the comparable period in 2002. The decrease was primarily due to decreased rates of return on cash, cash equivalents and short-term investments as compared to the prior year and the inclusion of \$490,000 in non-recurring other income in the prior year which were partially offset by a \$947,000 expense for the settlement of a patent dispute in the prior year.

*Provision (Benefit) for Income Taxes.* For the three and nine months ended September 30, 2003, the provision for income taxes was 23% of pretax income, respectively, compared to 38% and 42% of pretax loss for the three and nine months ended September 30, 2002, respectively. The income tax provision (benefit) for such interim periods reflects the Company's estimated annual income tax rate. The estimated provision (benefit) for income taxes differs from taxes computed at the federal statutory rate primarily due to the effect of state income taxes, state research and development credits, and state manufacturing credits.

## **MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)**

### **Liquidity and Capital Resources**

Since inception, the Company's principal sources of funding have been its cash from operations, bank borrowings and sales of common stock. Principal sources of liquidity at September 30, 2003 consisted of cash and cash equivalents of \$126.8 million and bank borrowing arrangements. Borrowing agreements consisted of \$5.0 million under a revolving line of credit. There were no borrowings under this agreement as of September 30, 2003 (for a discussion of borrowing arrangements, see Note 4 of Notes to Condensed Consolidated Financial Statements).

The Company's working capital increased by \$10.0 million to \$192.2 million as of September 30, 2003 from \$182.2 million as of December 31, 2002. The increase was primarily attributable to a \$9.4 million increase in cash and cash equivalents.

The Company's cash flows from operating activities were \$25.9 million for the nine months ended September 30, 2003 as compared to \$7.1 million for the same period in the prior year. This cash flow increase resulted primarily from a \$18.5 million increase in income from operations after adjustments for non-cash activities to \$30.7 million for the nine months ended September 30, 2003 as compared to a \$12.2 million during the comparable period in 2002.

The \$25.9 million in cash flows from operating activities generated by the Company in the nine months ended September 30, 2003 were primarily attributable to \$30.7 million in income from operations (net income of \$874,000 plus adjustments for non-cash activities of \$29.8 million) combined with a \$2.5 million decrease in inventory, which were partially offset by a \$4.3 million decrease in income taxes payable and a \$2.6 million increase in accounts receivable.

For the nine months ended September 30, 2002, the Company's cash flows from operating activities were \$7.1 million and were primarily attributable to \$12.2 million in income from operations (net loss of \$28.2 million plus adjustments for non-cash activities of \$40.5 million) which were partially offset by a \$5.2 million use in cash from changes in operating assets and liabilities.

The Company's investing activities during the nine months ended September 30, 2003 used cash of \$15.8 million as compared to \$26.0 million during the comparable period in the prior year. The \$10.2 million decrease in cash used compared to the same period in the prior year resulted primarily from a \$11.3 million decrease in net purchases of property, plant and equipment combined with a \$3.1 million decrease in net sales of short-term investments, which were partially offset by \$2.1 million for the purchase in intangible assets included in the prior year.

Cash used by investing activities during the nine months ended September 30, 2003 resulted from the purchase of \$15.8 million in net purchases of property, plant and equipment.

For the nine months ended September 30, 2002, the Company's investing activities used cash of \$26.0 million which resulted from \$27.0 million in net purchases of property, plant and equipment and \$2.1 million for the purchase of intangible assets, which was partially offset by \$3.1 million in net sales of short-term investments.

The Company's financing activities during the nine months ended September 30, 2003 used \$705,000 of cash as compared to \$12.4 million of cash used during the comparable period in the prior year. This \$11.7 million decrease in cash used compared to the same period in the prior year resulted primarily from a \$22.9 million decrease in the repurchase of common stock, which was partially offset by a \$10.7 million decrease in long-term debt borrowings combined with a \$2.7 million decreased in proceeds from the issuance of common stock.

Cash used by financing activities of \$705,000 during the nine months ended September 30, 2003 was the result of \$3.5 million in repurchases of common stock combined with \$735,000 in repayments of long-term debt, which were partially offset by \$3.5 million in proceeds from the issuance of common stock through employee stock transactions.

## **MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)**

For the nine months ended September 30, 2002, the Company's financing activities used cash of \$12.4 million as a result of \$26.4 million in repurchases of common stock and \$3.0 million in repayments of long-term debt which was partially offset by proceeds from long-term debt borrowings of \$10.7 million and proceeds from the issuance of common stock through employee stock transactions of \$6.3 million.

The Company currently intends to purchase approximately \$20 million to \$25 million in capital equipment and improvements during 2003. The majority of the anticipated 2003 capital spending is related to equipment and building improvements associated with the consolidation of wafer fabrication operations in its San Jose facility and new production mask sets. The Company also expects to purchase additional research and development related software and equipment, and manufacturing equipment for product testing of new products. The Company is currently authorized by its Board of Directors to repurchase an additional \$12.4 million of its common stock through March 31, 2004. The Company expects that its cash requirements for the next 12 months will be met by its cash from operations, existing cash balances and short-term investments, and its credit facility.

### **Recently Issued Accounting Standards**

In January 2003, the Financial Accounting Standards Board ("FASB" or the "Board") issued Interpretation No. 46 ("FIN 46") "Consolidation of Variable Interest Entities." FIN 46 requires certain variable interest entities to be consolidated by the primary beneficiary of the entity if the equity investors in the entity do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. FIN 46 is effective immediately for all new variable interest entities created or acquired after January 31, 2003. For variable interest entities created or acquired before February 1, 2003, the provisions of FIN 46 must be applied for the first interim or annual period beginning after December 15, 2003. The Company does not currently anticipate this statement to have any effect on its financial statements.

In November 2002, the Emerging Issues Task Force reached a consensus on Issue No. 00-21 ("EITF 00-21"), "Revenue Arrangements with Multiple Deliverables." EITF 00-21 provides guidance on how to account for arrangements that involve the delivery or performance of multiple products, services and/or rights to use assets. The provisions of EITF 00-21 will apply to revenue arrangements entered into in fiscal periods beginning after June 15, 2003. The adoption of this standard had no material impact on the Company's financial statements.

In May 2003, the FASB issued Statement of Accounting Standards No. 150 ("SFAS 150"), "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity." SFAS No. 150 changes the accounting guidance for certain financial instruments that, under previously guidance, could be classified as equity or "mezzanine" equity by now requiring those instruments to be classified as liabilities (or assets in some circumstances) in the statement of financial position. Further, SFAS No. 150 requires disclosure regarding the terms of those instruments and settlement alternatives. SFAS No. 150 is generally effective for all financial instruments entered into or modified after May 31, 2003, and is otherwise effective at the beginning of the first interim period beginning after June 15, 2003. While the effective date of certain elements of SFAS No. 150 have been deferred, the adoption of SFAS No. 150 when finalized is not expected to have a material impact on the Company's financial position, results of operations or cash flows.

### **Contractual Obligations and Commitments**

The Company's contractual obligations disclosure in its Annual Report on Form 10-K for the year ended December 31, 2002 has not materially changed since that report was filed. During the nine months ended September 30, 2003 payments of \$1.9 million were made under previously existing operating leases, payments of \$735,000 were made under previously existing long-term debt agreements and payments of \$2.0 million were made under previously existing other long-term liabilities.

## **MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)**

### **Factors That May Affect Operating Results**

The statements contained in this Report on Form 10-Q that are not purely historical are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, including statements regarding the Company's expectations, hopes, intentions or strategies regarding the future. Forward-looking statements include statements regarding: future products or product development; future research and development spending and the Company's product development strategy; the success of future cost reduction programs; the levels of domestic and international sales; future expansion or utilization of manufacturing capacity; future expenditures; and current or future acquisitions. All forward-looking statements included in this document are based on information available to the Company on the date hereof, and the Company assumes no obligation to update any such forward-looking statements. It is important to note that the Company's actual results could differ materially from those in such forward-looking statements. Some of the factors that could cause actual results to differ materially are set forth below. Additional factors that may affect operating results are contained within the Company's Form 10-K for the year ended December 31, 2002.

### **The Company's operating results may fluctuate because of a number of factors, many of which are beyond its control.**

If the Company's operating results are below the expectations of public market analysts or investors, then the market price of its Common Stock could decline. Some of the factors that affect or may affect the Company's quarterly and annual results, but which are difficult for the Company to control or predict are:

- the volume and timing of orders received
- changes in the mix of products sold
- market acceptance of the Company's products and its customers' products
- competitive pricing pressures
- cyclical semiconductor industry conditions
- dependence on third-party suppliers
- the ability to introduce new products on a timely basis
- the timing of new product announcements and introductions by the Company or its competitors
- the timing and extent of research and development expenses
- fluctuations in manufacturing yields
- the ability to hire and retain key technical and management personnel
- access to advanced process technologies
- the timing and extent of new process development costs

### **Customer demand for the Company's products is volatile and difficult to predict.**

The Company's customers continuously adjust their inventories in response to changes in end market demand for their products and the availability of semiconductor components. This results in frequent changes in demand for the Company's products. The volatility of customer demand limits the Company's ability to predict future levels of sales and profitability. The supply of semiconductors can quickly and unexpectedly match or exceed demand because end customer demand can change very quickly. Also, semiconductor suppliers can rapidly increase production output. This can lead to a sudden oversupply situation and a subsequent reduction in order rates and revenues as customers adjust their inventories to true demand rates. A rapid and sudden decline in customer demand for the Company's products can result in excess quantities of certain of the Company's products relative to demand. Should this occur the Company's operating results may be adversely affected as a result of charges to reduce the carrying value of the Company's inventory to the estimated demand level or market price.

The weakness in the global economy in 2001, 2002, and 2003 has caused the end markets that the Company's customers serve to grow less rapidly, or in some cases, contract. The resulting uncertainty of demand has caused most of the Company's customers to err on the side of caution until they see signs of order strength for their end products. Many customers are continuing to deplete inventories in response to short supplier lead times. Semiconductors are perceived to be readily available and supplier lead times remain near historic lows. In this

## **MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)**

environment, customers are not making large purchase commitments, only ordering small quantities to fill known short-term requirements, greatly reducing the Company's visibility into customer demand. As a result, the Company's revenues are highly dependent upon turns fill orders (orders booked and shipped in the same quarter). The reduced level of order backlog coupled with the short-term nature of customer demand makes it extremely difficult to predict near term revenues and profits.

The short lead time environment has allowed many end consumers of the Company's products to rely on stocking representatives and distributors to carry inventory to meet short term requirements and minimize their investment in on-hand inventory. As a result the Company may carry a higher level of inventory at some of its stocking representatives and distributors to service the volatile short-term demand of the end customer. Should the relationship with a distributor or stocking representative be terminated, future level of product returns could be higher than the returns allowance established, which could negatively affect the Company's revenues and results of operations.

### **The semiconductor industry is highly competitive.**

The semiconductor industry is highly competitive and subject to rapid technological change, price-erosion and increased international competition. Significant competitive factors include:

- product features
- performance
- price
- timing of product introductions
- emergence of new computer and communications standards
- quality and customer support

In times when economic growth and customer demand is less certain, such as the semiconductor industry is now experiencing, price competition becomes more prevalent. Both the semiconductor industry and the Company have experienced significant price erosion since the beginning of 2001. If this price erosion continues, it will have the effect of reducing revenue levels and gross margins in future periods.

Because the standard products market for integrated circuits is diverse and highly fragmented, the Company encounters different competitors in various market areas. Most of these competitors have substantially greater technical, financial and marketing resources and greater name recognition than the Company. Increased competition could adversely affect the Company's financial condition or results of operations. There can be no assurance that the Company will be able to compete successfully in either the standard products or custom and foundry products business in the future or that competitive pressures will not adversely affect the Company's financial condition, results of operations, or cash flows.

### **The Company's product offering, while diversified, is highly dependent on certain select end markets.**

The Company currently sells a significant portion of its products in the high-speed communications, computer, networking and wireless handset markets. These markets are characterized by short product life cycles, rapidly changing customer demand, evolving and competing industry standards and seasonal demand trends. Additionally, there can be no assurance that these markets will continue to grow. If the markets for high speed communications, computers, networking or wireless handsets that the Company serves fail to grow, or grow more slowly than it currently anticipates, or if there is increased competition in these markets, the Company's business, results of operations and financial condition could be adversely affected.

An important part of the Company's strategy is to continue to focus on the market for high-speed communications integrated circuits. If the severe downturn in the telecommunications infrastructure industry continues, resulting in lack of demand for the Company's high bandwidth products, the Company's future revenue growth and profitability could be adversely affected.

## **MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)**

The Company's Ethernet products have become an important portion of the Company's revenues. If the Company fails to develop new products to serve this market in a timely manner, or if the market acceptance of the Company's new Ethernet products is poor, if a competitor's products unfavorably affect pricing or demand for the Company's products, the Company's revenues and results of operations could be adversely affected.

The Company currently derives the majority of its product revenues from sales of standard analog and mixed-signal integrated circuits and expects these products to continue to account for the majority of its revenues for the foreseeable future. As a result, factors adversely affecting the pricing of or demand for standard analog integrated and mixed-signal circuits, such as competition, product performance or technological change, could have a material adverse effect on the Company's business and consolidated results of operations and financial condition.

The markets that the Company serves frequently undergo transitions in which products rapidly incorporate new features and performance standards on an industry-wide basis. If the Company's products are unable to support the new features or performance levels required by OEMs in these markets, it would likely lose business from existing or potential customers and would not have the opportunity to compete for new design wins until the next product transition. If the Company fails to develop products with required features or performance standards, or experiences even a short delay in bringing a new product to market, or if its customers fail to achieve market acceptance of their products, its revenues could be significantly reduced for a substantial period of time.

### **The cost reduction actions the Company has initiated may not materialize as expected, or be sustainable as business improves.**

The Company has implemented or initiated a variety of cost reduction actions. The expected future cost savings from these programs may not materialize as anticipated resulting in a smaller benefit to the Company's financial results of operations. Furthermore, when customer demand improves and revenues increase, it is unclear whether Micrel will continue to benefit from all of the cost reduction actions that have been implemented.

### **Dependence on third-party manufacturing and supply relationships increases the risk that the Company will not have an adequate supply of products to meet demand or that its cost of materials will be higher than expected.**

The Company faces many risks associated with its dependence upon third parties that manufacture, assemble or package certain of its products. These risks include:

- reduced control over delivery schedules and quality
- risks of inadequate manufacturing yields and excessive costs
- the potential lack of adequate capacity during periods of excess demand
- difficulties selecting and integrating new subcontractors
- limited warranties on wafers or products supplied to the Company
- potential increases in prices
- potential misappropriation of the Company's intellectual property

Any of these risks may lead to increased costs or delay delivery of the Company's products, which would harm its profitability and customer relationships.

Additionally, the Company's wafer and product requirements typically represent a relatively small portion of the total production of the third-party foundries and outside assembly, testing and packaging contractors. As a result, Micrel is subject to the risk that a foundry will provide delivery or capacity priority to other larger customers at the expense of Micrel, resulting in an inadequate supply to meet customer demand or higher costs to obtain the necessary product supply. Also, there is a risk that a third party manufacturer will cease production on an older or lower volume process that it uses to produce the Company's products. The Company cannot be certain that its outside manufacturers will continue to devote resources to the production of its products or continue to advance the process design technologies on which the manufacturing of its products are based. Each of these events could increase the Company's costs and harm its ability to deliver its products on time.

## **MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)**

**Market conditions may lead the Company to initiate additional cost reduction plans, which may negatively affect near term operating results.**

As a result of weak customer demand, competitive pricing pressures, excess capacity, weak economic conditions or other factors, the Company may decide to initiate additional actions to reduce the Company's cost structure and improve the Company's future operating results. The cost reduction actions may require incremental costs to implement, which could negatively affect the Company's operating results in periods when the incremental costs or liabilities are incurred.

**The Company encounters risks associated with its international operations, including geopolitical risks.**

Reduced levels of economic activity, or disruptions of international transportation, could adversely affect the Company's sales on either a global basis or in specific geographic regions. Three of the Company's top ten direct customers are located in South Korea. In the event that current political tensions surrounding North Korea evolve into military or social conflict, the Company's revenues, results of operations, cash flow and financial condition could be adversely affected.

The Company has generated a substantial portion of its net revenues from export sales. The Company believes that a substantial portion of its future net revenues will depend on export sales to customers in international markets, including Asia. International markets are subject to a variety of risks, including changes in policy by foreign governments, social conditions such as civil unrest, economic conditions including high levels of inflation, fluctuation in the value of foreign currencies and currency exchange rates and trade restrictions or prohibitions. In addition, the Company sells to domestic customers that do business worldwide and cannot predict how the businesses of these customers may be affected by economic or political conditions in Asia or elsewhere in the world. Such factors could adversely affect the Company's future revenues, financial condition, results of operations or cash flows.

The Company is reliant on certain key suppliers for wafer fabrication, circuit assembly and testing services. Most of these suppliers are based outside of the U.S. The Company's supply could be interrupted as a result of any of the previously mentioned risk factors relating to international markets.

The Company's international sales are denominated in U.S. currency. Consequently, changes in exchange rates that strengthen the U.S. dollar could increase the price of the Company's products in the local currencies of the foreign markets it serves. This would result in making the Company's products relatively more expensive than its competitors' products that are denominated in local currencies, leading to a reduction in sales or profitability in those foreign markets. The Company has not taken any protective measures against exchange rate fluctuations, such as purchasing hedging instruments.

**The Company's gross margin is dependent upon a number of factors, including the level of capacity utilization.**

Semiconductor manufacturing is a capital-intensive business resulting in high fixed costs. If the Company is unable to utilize its installed wafer fabrication or test capacity at a high level, the costs associated with these facilities and equipment would not be fully absorbed, resulting in higher average unit costs and lower sales margins. The level of new customer order rates over the past two years has resulted in lower capacity utilization of the Company's factories as it has attempted to match production with anticipated customer demand. The Company's gross margins have declined as a result of this reduced utilization of production capacity. Gross margins may deteriorate further should production activity be curtailed in response to lower customer demand in the future.

## **MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)**

**The Company is subject to the risk of litigation and regulatory action in connection with the restatement of its financial statements, and the potential liability from any such litigation or regulatory action could harm its business.**

On January 28, 2002, the Company announced that it would restate its consolidated financial statements for the fiscal years ended December 31, 1998, 1999, and 2000, and the fiscal quarters ended March 31, 2001, June 30, 2001, and September 30, 2001. As a result of this restatement, the Company could become subject to litigation or regulatory proceedings, or both. As of the date hereof, the Company is not aware of any litigation having been commenced against it related to this restatement. However, such litigation could be commenced against the Company in the future and, if so, the Company cannot predict the outcome of any such action at this time. However, if an unfavorable result occurred in any such action, the Company's business and financial condition could be harmed. In addition, regulatory agencies, such as the Securities and Exchange Commission, could commence a formal investigation of the Company's restatement. At this time management cannot predict whether or not any regulatory investigation related to the restatement will be commenced or, if it is, the outcome of any such investigation. However, if any such investigation were to result in a regulatory proceeding or action against the Company, its business and financial condition could be harmed. The restatement also involves certain tax issues that need to be resolved with the appropriate taxing authorities. The Company has recorded a liability in its financial statements with respect to these tax issues. The Company cannot predict the results of its discussions with the appropriate tax authorities regarding the tax implications of its restatement and accordingly, the amount of actual financial impact may differ from the amount recorded in the Company's financial statements.

**The Company may not be able to protect its intellectual property adequately, or could be harmed by litigation involving its patents and proprietary rights.**

The Company's future success depends in part upon its intellectual property, including patents, trade secrets, know-how and continuing technology innovation. There can be no assurance that the steps taken by the Company to protect its intellectual property will be adequate to prevent misappropriation or that others will not develop competitive technologies or products. There can be no assurance that any patent owned by the Company will not be invalidated, circumvented or challenged, that the rights granted thereunder will provide competitive advantages or that any of its pending or future patent applications will be issued with the scope of the claims sought, if at all. Furthermore, there can be no assurance that others will not develop technologies that are similar or superior to the Company's technology, duplicate technology or design around the patents owned by the Company. Additionally, the semiconductor industry is characterized by recurrent litigation regarding patent and other intellectual property rights. There can be no assurance that existing claims or any other assertions or claims for indemnity resulting from infringement claims will not adversely affect the Company's business, financial condition, results of operations, or cash flows.

**The Company's operating results substantially depend on manufacturing output and yields, which may not meet expectations.**

The Company manufactures most of its semiconductors at its San Jose, California fabrication facilities. Manufacturing semiconductors requires manufacturing tools that are unique to each product being produced. If one of these unique manufacturing tools was damaged or destroyed, the Company's ability to manufacture the related product would be impaired and its business would suffer until the tool was repaired or replaced. Additionally, the fabrication of integrated circuits is a highly complex and precise process. Small impurities, contaminants in the manufacturing environment, difficulties in the fabrication process, defects in the masks used to print circuits on a wafer, manufacturing equipment failures, wafer breakage or other factors can cause a substantial percentage of wafers to be rejected or numerous die on each wafer to be nonfunctional.



## **MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)**

**The Company's future success depends in part on the continued service of its key design engineering, sales, marketing and executive personnel and its ability to identify, hire and retain additional personnel.**

There is intense competition for qualified personnel in the semiconductor industry, in particular design engineers, and the Company may not be able to continue to attract and train engineers or other qualified personnel necessary for the development of its business or to replace engineers or other qualified personnel who may leave its employ in the future. Loss of the services of, or failure to recruit, key design engineers or other technical and management personnel could be significantly detrimental to the Company's product and process development programs.

**The Company faces risks associated with acquisitions it has completed and will face risks associated with any future acquisitions.**

The Company has made acquisitions in the past and may make acquisitions in the future. The risks involved with acquisitions include:

- diversion of management's attention
- failure to retain key personnel
- amortization of acquired intangible assets
- customer dissatisfaction or performance problems with the acquired company
- the cost associated with acquisitions and the integration of acquired operations
- assumption of unknown liabilities

Any of these risks could materially harm the Company's business, financial condition and results of operations. Additionally, any acquisition involves a significant amount of integration of two companies that have previously operated independently. No assurance can be given that difficulties will not be encountered in integrating certain products, technologies or operations of the acquired companies or that the benefits expected from such integration will be realized. There can be no assurance that any of the acquired companies will retain its key personnel, that the engineering teams of Micrel and the acquired companies will successfully cooperate and realize any technological benefits or that Micrel or the acquired companies will realize any of the other anticipated benefits of the acquisitions. In addition, the consummation of an acquisition could result in the cancellation, termination or non-renewal of arrangements with the acquired company by suppliers, distributors or customers, or the termination of negotiations or delays in ordering by prospective customers as a result of uncertainties that may be perceived as a result of the acquisition. Any significant amount of cancellations, terminations, delays or non-renewals of arrangements with the acquired company or loss of key employees or termination of negotiations or delays in ordering could have a material adverse effect on the business, operating results or financial condition of the acquired company and Micrel after the acquisition.

In addition, some of the past acquisitions have been accounted for using the pooling-of-interests method of accounting which means the acquisitions are subject to rules established by the Financial Accounting Standards Board and the Securities and Exchange Commission. These rules are complex and the interpretation of them is subject to change. Additionally, the availability of pooling of interests accounting treatment for a business combination depends in part upon circumstances and events occurring after the acquisition. The failure of a past business combination that has been accounted for under the pooling of interests accounting method to qualify for this accounting treatment would materially harm the Company's reported and future earnings and likely, the price of its Common Stock.

**The Company's ability to manufacture sufficient wafers to meet demand could be severely hampered by natural disasters.**

The Company's existing wafer fabrication facility is located in Northern California and this facility may be subject to natural disasters such as earthquakes. A significant natural disaster, such as an earthquake or prolonged drought, could have a material adverse impact on the Company's business, financial condition and operating results.

## **MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)**

### **The Company's business could be adversely affected by electrical power or natural gas supply interruptions.**

The majority of the Company's administrative, technical and manufacturing facilities are located in Northern California and these facilities may be subject to electrical power or natural gas supply interruptions. In recent months, electrical power suppliers have experienced shortages in electrical power, which has resulted in brief electrical power interruptions. The weak financial condition of California's Public Utilities may aggravate the situation and shortages may develop for natural gas. Semiconductor manufacturing depends upon a controlled environment that requires high usage of electrical power and natural gas. Frequent or extended electrical power interruptions could have a negative impact on production output, manufacturing yields, and manufacturing efficiencies and could have a material adverse impact on the Company's business, financial condition and operating results.

### **The Company could incur substantial fines or litigation costs associated with its storage, use and disposal of hazardous materials.**

The Company is subject to a variety of federal, state and local governmental regulations related to the use, storage, discharge and disposal of toxic, volatile or otherwise hazardous chemicals used in its manufacturing process. Any failure to comply with present or future regulations could result in the imposition of fines, the suspension of production, alteration of the Company's manufacturing processes or a cessation of operations. In addition, these regulations could restrict the Company's ability to expand its facilities at their present locations or construct or operate a new wafer fabrication facility or could require us to acquire costly equipment or incur other significant expenses to comply with environmental regulations or clean up prior discharges. The Company's failure to appropriately control the use of, disposal or storage of, or adequately restrict the discharge of, hazardous substances could subject it to future liabilities and could have a material adverse effect on its business.

## **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

The Company's market risk disclosures set forth in the Company's 2002 Form 10-K for the year ended December 31, 2002 have not changed significantly during the nine months ended September 30, 2003.

## **ITEM 4: CONTROLS AND PROCEDURES**

The Company maintains disclosure controls and procedures that are designed to ensure that information required to be disclosed in the Company's reports under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission, and that such information is accumulated and communicated to the Company's management, including its chief executive officer and chief financial officer, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management necessarily is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

As required by Securities and Exchange Commission Rule 13a-15(b), the Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's chief executive officer and chief financial officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures as of the end of the quarter covered by this report. Based on the foregoing, the Company's chief executive officer and chief financial officer concluded that the Company's disclosure controls and procedures appear to be effective at the reasonable assurance level.

There has been no change in the Company's internal controls over financial reporting during the Company's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Company's internal controls over financial reporting.

## **PART II. OTHER INFORMATION**

### **ITEM 1. LEGAL PROCEEDINGS**

The information included in Note 8 of Notes to Condensed Consolidated Financial Statements under the caption "Litigation and Other Contingencies" in Item 1 of Part I is incorporated herein by reference.

### **ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS**

- (a) None.
- (b) Dividend Payment Restrictions

The Company has entered into borrowing agreements that contain restrictions on the declaration and payment of dividends without the lender's consent. In addition, the Company currently intends to retain future earnings to fund operations, and does not anticipate paying dividends on its common stock in the foreseeable future.

- (c) None.
- (d) Not applicable.

### **ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K**

- (a) Exhibits.

<u>Exhibit No.</u>	<u>Description</u>
31	Certifications of the Company's Chief Executive Officer and Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32	Certifications of the Company's Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

- (b) Reports on Form 8-K. During the three months ended September 30, 2003, the Company furnished a Current Report on Form 8-K, on July 2, 2003, announcing its revised outlook for the quarter ending June 30, 2003. In addition, on July 23, 2003, the Company furnished a Current Report on Form 8-K announcing its results of operations for the quarter ended June 30, 2003.

## **SIGNATURE**

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

**MICREL, INCORPORATED**  
*(Registrant)*

Date: November 13, 2003

By /s/ Richard D. Crowley, Jr.  
Richard D. Crowley, Jr.  
Vice President, Finance and  
Chief Financial Officer  
*(Authorized Officer and  
Principal Financial Officer)*

**Certification of Chief Executive Officer  
Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002**

I, Raymond D. Zinn, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Micrel, Incorporated;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
  - a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - c) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):
  - a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 13, 2003

By /s/ Raymond D. Zinn  
Raymond D. Zinn  
President, Chief Executive Officer and Director  
(Principal Executive Officer)

**Certification of Chief Financial Officer**  
**Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002**

I, Richard D. Crowley, Jr. certify that:

1. I have reviewed this quarterly report on Form 10-Q of Micrel, Incorporated;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
  - a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - c) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):
  - a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 13, 2003

By /s/ Richard D. Crowley, Jr.  
Richard D. Crowley, Jr.  
Vice President, Finance and  
Chief Financial Officer  
(Principal Financial and Accounting Officer)

**Certification of Chief Executive Officer  
Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002**

Pursuant to 18 U.S.C. § 1350, as created by Section 906 of the Sarbanes-Oxley Act of 2002, the undersigned officer of Micrel, Incorporated (the "Company") hereby certifies, to such officer's knowledge, that:

- (i) the accompanying Quarterly Report on Form 10-Q of the Company for the quarterly period ended September 30, 2003 (the "Report") fully complies with the requirements of Section 13(a) or Section 15(d), as applicable, of the Securities Exchange Act of 1934, as amended; and
- (ii) the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated: November 13, 2003

/s/ Raymond D. Zinn  
Raymond D. Zinn  
Chief Executive Officer

**Certification of Chief Financial Officer**  
**Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002**

Pursuant to 18 U.S.C. § 1350, as created by Section 906 of the Sarbanes-Oxley Act of 2002, the undersigned officer of Micrel, Incorporated (the "Company") hereby certifies, to such officer's knowledge, that:

- (i) the accompanying Quarterly Report on Form 10-Q of the Company for the quarterly period ended September 30, 2003 (the "Report") fully complies with the requirements of Section 13(a) or Section 15(d), as applicable, of the Securities Exchange Act of 1934, as amended; and
- (ii) the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated: November 13, 2003

/s/ Richard D. Crowley  
Richard D. Crowley  
Chief Financial Officer