

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, 2005.

or

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

For the transition period from _____ to _____.

Commission File Number **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 ☐

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

As of October 31, 2005 there were 85,872,280 shares of common stock, no par value, outstanding.

MICREL, INCORPORATED
INDEX TO
REPORT ON FORM 10-Q
FOR THE THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2005

Page

PART I. FINANCIAL INFORMATION

Item 1.	Financial Statements:	
	Condensed Consolidated Balance Sheets - September 30, 2005 and December 31, 2004	3
	Condensed Consolidated Statements of Operations - Three and Nine Months Ended September 30, 2005 and 2004	4
	Condensed Consolidated Statements of Cash Flows - Nine Months Ended September 30, 2005 and 2004	5
	Notes to Condensed Consolidated Financial Statements	6
Item 2.	Management's Discussion and Analysis of Financial Condition and Results of Operations	15
Item 3.	Quantitative and Qualitative Disclosures about Market Risk	27
Item 4.	Controls and Procedures	27

PART II. OTHER INFORMATION

Item 1.	Legal Proceedings	28
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	28
Item 6.	Exhibits	28
	Signature	30

ITEM 1. FINANCIAL STATEMENTS

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

	September 30, 2005	December 31, 2004 ⁽¹⁾
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	\$ 104,333	\$ 101,282
Short term investments	36,477	46,503
Accounts receivable, net	35,915	32,055
Inventories	28,710	35,744
Other current assets	1,460	2,488
Deferred income taxes	<u>16,293</u>	<u>15,962</u>
Total current assets	223,188	234,034
PROPERTY, PLANT AND EQUIPMENT, NET	77,741	81,605
LONG TERM INVESTMENTS	--	2,012
DEFERRED INCOME TAXES	11,062	9,663
INTANGIBLE ASSETS, NET	5,158	6,375
OTHER ASSETS	<u>419</u>	<u>457</u>
TOTAL	<u><u>\$ 317,568</u></u>	<u><u>\$ 334,146</u></u>
LIABILITIES AND SHAREHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Accounts payable	\$ 15,870	\$ 16,275
Taxes payable	4,038	4,960
Deferred income on shipments to distributors	12,559	13,648
Other current liabilities (NOTE 5)	20,370	12,165
Current portion of long-term debt	<u>153</u>	<u>164</u>
Total current liabilities	52,990	47,212
LONG-TERM DEBT	--	83
OTHER LONG-TERM OBLIGATIONS	656	1,964
SHAREHOLDERS' EQUITY:		
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: 2005 – 86,248,688 shares; 2004 – 89,825,994 shares	90,058	127,264
Deferred stock compensation	(415)	(1,118)
Accumulated other comprehensive loss	(54)	(85)
Retained earnings	<u>174,333</u>	<u>158,826</u>
Total shareholders' equity	<u>263,922</u>	<u>284,887</u>
TOTAL	<u><u>\$ 317,568</u></u>	<u><u>\$ 334,146</u></u>

(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, 2004.

The accompanying notes are an integral part of these 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,	
	2005	2004	2005	2004
NET REVENUES	\$ 62,472	\$ 67,853	\$ 185,209	\$ 198,110
COST OF REVENUES ⁽¹⁾ (NOTE 12)	28,680	34,598	88,889	102,933
GROSS PROFIT	33,792	33,255	96,320	95,177
OPERATING EXPENSES:				
Research and development (NOTE 12)	11,337	11,145	34,011	31,390
Selling, general and administrative (NOTE 12)	11,527	9,955	31,563	27,394
Amortization of deferred stock compensation ⁽¹⁾	117	487	516	1,659
Purchased in-process technology	--	--	--	480
Restructuring expense	--	437	--	437
Litigation accrual	--	--	9,282	--
Total operating expenses	22,981	22,024	75,372	61,360
INCOME FROM OPERATIONS	10,811	11,231	20,948	33,817
OTHER INCOME, NET	1,068	363	2,909	901
INCOME BEFORE INCOME TAXES	11,879	11,594	23,857	34,718
PROVISION FOR INCOME TAXES (NOTE 12)	4,158	4,058	8,350	8,559
NET INCOME	<u>\$ 7,721</u>	<u>\$ 7,536</u>	<u>\$ 15,507</u>	<u>\$ 26,159</u>
NET INCOME PER SHARE:				
Basic	<u>\$ 0.09</u>	<u>\$ 0.08</u>	<u>\$ 0.18</u>	<u>\$ 0.28</u>
Diluted	<u>\$ 0.09</u>	<u>\$ 0.08</u>	<u>\$ 0.18</u>	<u>\$ 0.28</u>
WEIGHTED-AVERAGE SHARES USED IN COMPUTING PER SHARE AMOUNTS:				
Basic	<u>86,514</u>	<u>91,252</u>	<u>87,604</u>	<u>91,968</u>
Diluted	<u>88,047</u>	<u>91,996</u>	<u>88,512</u>	<u>93,735</u>
(1) Amortization of deferred stock compensation included in cost of revenues	<u>\$ 35</u>	<u>\$ 109</u>	<u>\$ 127</u>	<u>\$ 479</u>
Amortization of deferred stock compensation included in operating expenses related to:				
Research and development	\$ 32	\$ 173	\$ 135	\$ 609
Selling, general and administrative	85	314	381	1,050
Total operating expenses	<u>\$ 117</u>	<u>\$ 487</u>	<u>\$ 516</u>	<u>\$ 1,659</u>

The accompanying notes are an integral part of these condensed consolidated financial statements.

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

(In thousands)

	Nine Months Ended September 30,	
	2005	2004
NET CASH FLOWS PROVIDED BY OPERATING ACTIVITIES:		
Net income	\$ 15,507	\$ 26,159
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	15,429	18,816
Stock based compensation	643	2,138
Purchased in-process technology	--	480
Loss on disposal of assets	100	114
Deferred rent	(73)	--
Deferred income taxes	(1,730)	10,200
Changes in operating assets and liabilities, net of effect of acquisition:		
Accounts receivable	(3,860)	(5,400)
Inventories	7,034	(5,930)
Prepaid expenses and other assets	1,066	693
Accounts payable	(405)	4,749
Income taxes	(1,554)	(2,294)
Other accrued liabilities	6,970	(972)
Deferred income on shipments to distributors	(1,089)	4,064
Net cash provided by operating activities	<u>38,038</u>	<u>52,817</u>
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property, plant and equipment	(10,448)	(13,558)
Purchase of intangible assets	--	(1,030)
Proceeds (purchases) of short-term investments, net	12,069	(35,096)
Purchases of long-term investments	--	(3,185)
Purchase of BlueChip Communications, net of cash acquired	--	(2,033)
Net cash provided by (used in) investing activities	<u>1,621</u>	<u>(54,902)</u>
CASH FLOWS FROM FINANCING ACTIVITIES:		
Repayments of long-term debt	(94)	(587)
Proceeds from the issuance of common stock, net	6,291	3,958
Repurchase of common stock	(42,805)	(29,024)
Net cash used in financing activities	<u>(36,608)</u>	<u>(25,653)</u>
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	3,051	(27,738)
CASH AND CASH EQUIVALENTS - Beginning of period	<u>101,282</u>	<u>140,059</u>
CASH AND CASH EQUIVALENTS - End of period	<u>\$ 104,333</u>	<u>\$ 112,321</u>
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Cash paid during the period for:		
Interest	<u>\$ 193</u>	<u>\$ 262</u>
Income taxes	<u>\$ 10,795</u>	<u>\$ 964</u>
Non-cash transactions:		
Deferred stock compensation (reversal)	<u>\$ (60)</u>	<u>\$ (218)</u>
The accompanying notes are an integral part of these 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, 2005 and for the three and nine months ended September 30, 2005 and 2004 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 statement 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, 2004. This financial data should also be read in conjunction with the Company's critical accounting policies included in the Company's Annual Report on Form 10-K for the year ended December 31, 2004.

Certain prior year amounts have been reclassified to conform to the current-year presentation. These reclassifications had no impact on our results of operations or changes in stockholders' equity.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
Weighted-average common shares outstanding	86,514	91,252	87,604	91,968
Dilutive effect of stock options outstanding using the treasury stock method	<u>1,533</u>	<u>744</u>	<u>908</u>	<u>1,767</u>
Shares used in computing diluted net income per share	<u><u>88,047</u></u>	<u><u>91,996</u></u>	<u><u>88,512</u></u>	<u><u>93,735</u></u>

For the three and nine months ended September 30, 2005, approximately 5.0 million and 7.7 million stock options, respectively, have been excluded from the weighted-average number of common shares outstanding for the diluted net income per share computations as they were anti-dilutive. For the three and nine months ended September 30, 2004, 7.7 million and 4.7 million stock options, respectively, have been excluded from the weighted-average number of common shares outstanding for the diluted net income 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". During the years 1996 through December 2001, certain of the Company's option pricing practices resulted in stock compensation expense under APB 25 (for a further discussion, see Stock-based Awards included in Note 1 of Notes to Consolidated Financial Statements in the Company's Annual Report on Form 10-K for the year ended December 31, 2004). Deferred stock compensation expense 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, 2005 total unamortized stock compensation was \$415,000 with an anticipated remaining future amortization schedule of \$120,000 in 2005.

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 as of the beginning of fiscal 1995. Under SFAS No. 123, the fair value of stock-based awards to employees is calculated through the use of option pricing models,

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

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. Calculations are based on a multiple option valuation approach with forfeitures recognized as they occur and the following weighted average assumptions:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
Expected life (months)	60	60	60	60
Stock volatility	76.0%	85.2%	78.8%	83.9%
Risk free interest rates	4.2%	3.4%	4.0%	3.3%
Dividends during expected terms	none	none	none	none

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 the following weighted average assumptions:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
Expected life (months)	6	6	6	6
Stock volatility	76.0%	85.2%	78.8%	83.9%
Risk free interest rates	3.8%	2.0%	3.4%	1.5%
Dividends during expected terms	none	none	none	none

SFAS No. 148 was issued in December 2002 and amended SFAS No. 123 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 and net income 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):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
Net income as reported	\$ 7,721	\$ 7,536	\$ 15,507	\$ 26,159
Add: stock-based employee compensation expense included in reported net income, net of tax effects	92	362	391	1,300
Deduct: stock-based employee compensation expense determined under fair value based method, net of tax effects	(1,893)	(4,012)	(7,541)	(12,302)
Pro forma net income	<u>\$ 5,920</u>	<u>\$ 3,887</u>	<u>\$ 8,357</u>	<u>\$ 15,157</u>
Net income per share as reported:				
Basic	<u>\$ 0.09</u>	<u>\$ 0.08</u>	<u>\$ 0.18</u>	<u>\$ 0.28</u>
Diluted	<u>\$ 0.09</u>	<u>\$ 0.08</u>	<u>\$ 0.18</u>	<u>\$ 0.28</u>
Pro forma net income per share:				
Basic	<u>\$ 0.07</u>	<u>\$ 0.04</u>	<u>\$ 0.10</u>	<u>\$ 0.16</u>
Diluted	<u>\$ 0.07</u>	<u>\$ 0.04</u>	<u>\$ 0.10</u>	<u>\$ 0.17</u>

For the three and nine months ended September 30, 2004, pro forma stock compensation amounts have been adjusted to correct for the estimated tax effect of various stock option grants. This correction resulted in a decrease of \$1.0 million (\$0.02 per diluted share) and \$3.3 million (\$0.03 per diluted share), respectively in pro forma net income for the applicable 2004 periods presented herein.

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

2. RECENTLY ISSUED ACCOUNTING STANDARDS

In March 2004, the Financial Accounting Standards Board ("FASB") Emerging Issues Task Force ("EITF") reached a consensus on recognition and measurement guidance previously discussed under EITF Issue No. 03-01, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments." ("EITF 03-01"). The consensus clarifies the meaning of other-than-temporary impairment and its application to investments in debt and equity securities, in particular investments within the scope of FASB Statement No. 115, "Accounting for Certain Investments in Debt and Equity Securities," and investments accounted for under the cost method. In September 2004, the FASB delayed the accounting provisions of EITF Issue No. 03-01; however the disclosure requirements remain effective and were adopted by the Company as of the year ended December 31, 2004. The Company will evaluate the effect, if any, of EITF Issue No. 03-01 when final guidance is issued.

In November 2004, the FASB issued Statement of Financial Accounting Standards ("SFAS") No. 151, "Inventory Costs," which clarifies the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material. Companies will no longer be permitted to capitalize inventory costs on their balance sheets when the production defect rate varies significantly from the expected rate as SFAS No. 151 requires that those items be recognized as current-period charges regardless of whether they meet the criterion of "so abnormal". It also makes clear that fixed overhead should be allocated based on "normal capacity" of the production facilities. SFAS No. 151 will be effective for inventory costs incurred during fiscal years beginning after June 15, 2005, which is 2006 for calendar year companies. The Company is currently evaluating the potential impacts, if any, that the adoption of SFAS No. 151 may have on the Company's consolidated financial statements.

In December 2004, the FASB issued SFAS No. 123R, "Share-Based Payment." SFAS No. 123R is a revision of SFAS No. 123, and supersedes APB 25. Among other items, SFAS No. 123R eliminates the use of APB 25 and the intrinsic value method of accounting, and requires companies to recognize the cost of employee services received in exchange for awards of equity instruments, based on the fair value of those awards as of the grant date, in the financial statements. As a result of the SEC's April 2005 deferral of the effective date of SFAS No. 123R, the Company will be required to adopt SFAS No. 123R effective January 1, 2006., although early adoption is allowed. SFAS No. 123R permits companies to adopt its requirements using either a "modified prospective" method, or a "modified retrospective" method. Under the "modified prospective" method, compensation cost is recognized in the financial statements beginning with the effective date, based on the requirements of SFAS No. 123R for all share-based payments granted after that date, and based on the requirements of SFAS No. 123 for all unvested awards granted prior to the effective date of SFAS No. 123R. Under the "modified retrospective" method, the requirements are the same as under the "modified prospective" method, but also permits entities to restate financial statements of previous periods based on proforma disclosures made in accordance with SFAS No. 123.

In May 2005, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards (SFAS) No. 154, "Accounting Changes and Error Corrections." This statement generally requires retrospective application to prior periods' financial statements of voluntary changes in accounting principles. Under the prior rules, changes in accounting principles were generally recognized by including in net income of the period of the change the cumulative effect of changing to the new accounting principle. This statement does not change the previous guidance for reporting the correction of an error in previously issued financial statements, change in accounting estimate or justification of a change in accounting principle on the basis of preferability. This statement is effective for accounting changes made in fiscal years beginning after December 15, 2005. Management does not expect the adoption of this standard to have a material effect on the Company's consolidated financial statements.

The Company currently utilizes a standard option pricing model (Black-Scholes) to measure the fair value of stock options granted to employees. While SFAS No. 123R permits entities to continue to use such a model, the standard also permits the use of a "lattice" model. The Company has not yet determined which model it will use to measure the fair value of employee stock options upon the adoption of SFAS No. 123R.

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

The Company currently expects to adopt SFAS 123R in the quarter and year beginning January 1, 2006; however, the Company has not yet determined which of the aforementioned adoption methods it will use. Subject to a complete review of the requirements of SFAS 123R, the Company expects that the adoption of SFAS 123R may have a material adverse impact on its results of operations.

3. INVESTMENTS

Short-term and long-term investments consist primarily of liquid debt instruments and are classified as available-for-sale securities and are stated at market value with unrealized gains and losses included in shareholders' equity. Unrealized losses are charged against income when a decline in the fair market value of an individual security is determined to be other than temporary. Realized gains and losses on investments are included in other income or expense. Investments purchased with remaining maturity dates of greater than three months and less than 12 months are classified as short-term. Investments purchased with remaining maturity dates of 12 months or greater are classified either as short-term or as long-term based on maturities and the Company's intent with regards to those securities (expectations of sales and redemptions). A summary of investments at September 30, 2005 is as follows (in thousands):

	<u>Amortized Cost</u>	<u>Market Value</u>	<u>Unrealized Holding Gains</u>	<u>Unrealized Holding Losses</u>
Short-term investments	\$ 36,531	\$ 36,477	\$ --	\$ 54

As of September 30, 2005, all investments with unrealized loss positions have been in such positions for twelve months or less.

4. INVENTORIES

Inventories consist of the following (in thousands):

	<u>September 30, 2005</u>	<u>December 31, 2004</u>
Finished goods	\$ 10,290	\$ 15,912
Work in process	17,538	18,585
Raw materials	882	1,247
	<u>\$ 28,710</u>	<u>\$ 35,744</u>

5. OTHER CURRENT LIABILITIES

Other current liabilities consist of the following (in thousands):

	<u>September 30, 2005</u>	<u>December 31, 2004</u>
Accrued current liability under patent license agreement	\$ --	\$ 1,852
Accrued current restructuring expenses	2,021	2,021
Accrued workers compensation and health insurance	1,945	1,555
Accrued litigation	9,282	--
Accrued compensation	4,876	4,899
Accrued commissions	1,342	1,292
All other current accrued liabilities	904	546
Total other current liabilities	<u>\$ 20,370</u>	<u>\$ 12,165</u>

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

6. BORROWING ARRANGEMENTS

Borrowing arrangements consist of a \$6 million revolving line of credit from a commercial bank. The revolving line of credit agreement includes a provision for the issuance of commercial or standby letters of credit by the bank on behalf of the Company. The value of all letters of credit outstanding reduces the total line of credit available. There were no borrowings under the revolving line of credit at September 30, 2005, and there were \$875,000 in standby letters of credit outstanding. The revolving line of credit agreement expires on June 30, 2006. Borrowings under the revolving line of credit bear interest rates of, at the Company's election, the prime rate (6.75% at September 30, 2005), or the bank's revolving offshore rate, which approximates LIBOR (4.1% at September 30, 2005) 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, 2005.

Associated with the acquisition of BlueChip Communications, the Company has \$153,000 outstanding in term notes payable to the Norwegian Industrial and Regional Development Fund.

7. SIGNIFICANT CUSTOMERS

During the nine months ended September 30, 2005, three customers, a direct original equipment manufacturer ("OEM"), a world wide distributor and an Asian based stocking representative accounted for \$28.8 million (16%), \$21.4 million (12%) and \$21.3 million (12%) of net revenues, respectively. During the nine months ended September 30, 2004, two customers, a world wide distributor and an Asian based stocking representative accounted for \$27.5 million (14%) and \$26.7 million (13%) of net revenues, respectively, and no direct original equipment manufacturer ("OEM") accounted for 10% or more of net revenues.

At September 30, 2005, three customers accounted for 21%, 14% and 13% of total accounts receivable. At December 31, 2004, two customers accounted for 18% and 15% of total accounts receivable.

8. COMPREHENSIVE INCOME

Comprehensive income, which is comprised of the Company's net income for the periods and changes in unrealized gains or losses on investments was equal to net income for the three and nine months ended September 30, 2005 and 2004.

9. 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. 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 has 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 reportable segments. Also, the chief operating decision maker does not assign assets to these segments. Consequently, it is not practical to show assets by reportable segments.

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

Net Revenues by Segment
(Dollars in thousands)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
Net Revenues:				
Standard Products	\$ 59,532	\$ 65,332	\$ 177,660	\$ 190,084
Custom and Foundry Products	2,940	2,521	7,549	8,026
Total net revenues	<u>\$ 62,472</u>	<u>\$ 67,853</u>	<u>\$ 185,209</u>	<u>\$ 198,110</u>
As a Percentage of Total Net Revenues:				
Standard Products	95%	96%	96%	96%
Custom and Foundry Products	5%	4%	4%	4%
Total net revenues	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>

10. 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. A claim construction hearing has not yet been scheduled. 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 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. After many years of motions and appeals, a claim construction hearing (also called a “Markman” hearing) was held before the District Court on December 16, 2003. The Court issued its ruling on January 24, 2004, interpreting the claims at issue in the litigation. Furthermore, the parties have attended three settlement conferences before the District Court. A trial date has been set for November 28, 2005. 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. On July 22, 2005, a jury ruled against the Company and in favor of TRW in its counter claim against Micrel. The outcome of the jury trial was a judgment on July 26, 2005 awarding damages for the benefit of TRW in the amount of \$9.3 million. The damages amount was accrued in the Company’s second quarter 2005 financial statements. On August 9, 2005, the Company filed a Motion for an order setting aside the jury verdict and the subsequent judgment and granting a new trial on the issue of the Company’s breach of contract claim against TRW.

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

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 and the harm to Micrel in both financial and semiconductor markets resulting in loss of overall value of the company as a whole. Deloitte has denied all allegations in the complaint. 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 and pre-trial phase. A trial date has been set for January 9, 2006.

On November 11, 2004, the Company filed a complaint against Monolithic Power Systems (“MPS”), entitled *Micrel, Inc. v. Monolithic Power Systems*, in the United States District Court, Northern District of California (the “Court”) alleging two causes of action for infringement by MPS of certain patents owned by Micrel. In the complaint, the Company alleges that MPS has been and is infringing U.S. patent no. 5,517,046 (the “’046 patent”) and U.S. patent no. 5,556,796 (the “’796 patent”). Micrel alleges damages attributable to MPS’ infringement of the ’046 and ’796 patents as a direct result of MPS’ actions, including treble damages for wanton, deliberate, malicious and willful conduct. Subsequently, on November 29, 2004 the Company filed an amended complaint adding Michael R. Hsing, MPS’ President and Chief Executive Officer (“Hsing”), and James C. Moyer, MPS’ Chief Design Engineer (“Moyer”) as defendants. Hsing and Moyer are both former employees of Micrel. In addition to the original two causes of action against MPS for infringement of the ’046 and ’796 Patents, the amended complaint adds causes of action for statutory and common law misappropriation of Micrel’s trade secrets, breach of confidentiality agreements by Hsing and Moyer, and violation of California’s Unfair Competition Law. The amended complaint seeks compensatory damages, costs of suit and such other relief that the Court may deem proper. On December 16, 2004, MPS filed a Motion to Dismiss the Company’s claims for statutory and common law misappropriation of Micrel’s trade secrets. On April 8, 2005, the Court granted MPS’ Motion to Dismiss with leave to amend the complaint. On May 2, 2005, Micrel filed a second amended complaint for patent infringement, misappropriation of trade secrets, common law misappropriation, breach of confidentiality agreement, and statutory unfair competition. On May 23, 2005, MPS filed a Motion to Dismiss the Company’s claims for statutory and common law misappropriation of trade secrets contained in the second amended complaint. A hearing was held on September 30, 2005 on MPS’ Motion to Dismiss. The Court has not yet issued a ruling on the Motion.

With the exception of the TRW litigation discussed above, for which the company has recorded \$9.3 million in litigation expense, the Company believes that the ultimate outcome of the legal actions discussed will not result in a material adverse effect on the Company’s financial condition, results of operation or cash flows, and the Company believes it is not reasonably possible that a material loss has been incurred. 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.

The semiconductor industry is characterized by frequent litigation regarding patent and other intellectual property rights. To the extent that the Company becomes involved in such intellectual property litigation, in addition to litigation mentioned herein, 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

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

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. Based on the status of the litigation described above, the Company does not believe that any material and specific risk exists related to the loss of use of patents, products or processes.

Certain additional claims have been filed by or 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.

11. STOCK REPURCHASE PROGRAM

In March 2005, Micrel's Board of Directors approved a \$75 million share repurchase program for calendar year 2005. 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) plan. During the nine months ended September 30, 2005, the Company repurchased, 4,250,900 shares of its common stock for \$42.8 million.

12. INCOME TAXES

Deferred tax assets and liabilities result primarily from temporary differences between book and tax bases of assets and liabilities, state and federal research and development credit carryforwards and state manufacturers credit carryforwards. The Company had net current deferred tax assets of \$16.3 million and net long-term deferred tax assets of \$11.1 million as of September 30, 2005. The Company must regularly assess the likelihood that future taxable income levels will be sufficient to ultimately realize the tax benefits of these deferred tax assets. The Company currently 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. Should the Company determine that future realization of these tax benefits is not likely, a valuation allowance would be established, which would increase the Company's tax provision in the period of such determination.

The calculation of the Company's tax liabilities involves dealing with uncertainties in the application of complex tax regulations. The Company records liabilities for anticipated tax audit issues based on its estimate of whether, and the extent to which, additional taxes may be due. Actual tax liabilities may be different than the recorded estimates and could result in an additional charge or benefit to the tax provision in the period when the ultimate tax assessment is determined.

During the second quarter of 2004, the Company reversed \$3.8 million of accrued income tax liabilities as a result of the completion of a federal income tax audit. In May 2004, the Company received an audit report from the Internal Revenue Service ("IRS") which recommended no changes to Micrel's federal tax return filings covering the tax years 1994 through 2001. In addition, the Company subsequently received a notice dated July 6, 2004 from the Joint Committee on Taxation which stated that the committee took no exceptions to conclusions in the IRS audit report. This reversal of accrued income tax liabilities was recorded as a reduction to provision for income taxes in the second quarter of 2004.

In addition, related to the federal tax audit completion, the Company also reversed \$3.9 million (offset in part by a \$1.4 million income tax effect) in accrued payroll tax liabilities, which were previously recorded as part of the Company's restatement of financials for the years December 31, 1998, 1999, and 2000, and the quarters ended March 31, 2001, June 30, 2001, and September 30, 2001 to reflect previously unrecorded stock compensation expense and related payroll tax and income tax effects.

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

The effects of these accrued tax liability reversals on the below-noted items in the Company's statement of operations is summarized as follows:

	Nine Months Ended September 30, 2004
Cost of revenues	\$ (1,111)
Research and development	(1,697)
Selling, general and administrative	(1,140)
Provision for income taxes	(2,378)
	<u>\$ (6,326)</u>

The income tax provision for the three and nine months ended September 30, 2005 is based on the Company's estimated annual effective tax rate of 35% of pretax income. The income tax provision for the three and nine months ended September 30, 2004 was based on the Company's estimated annual effective tax rate of 35% of pretax income, reduced by the \$3.8 million reversal of accrued income tax liabilities recorded in the quarter ended June 30, 2004 and increased by \$168,000 as a result of \$480,000 of non-deductible purchased in-process technology charges recorded in the three months ended March 31, 2004.

13. RESTRUCTURING AND MANUFACTURING FACILITY IMPAIRMENT

During 2003 the Company closed its Santa Clara wafer fabrication facility. A summary of restructuring expense accruals associated with this facility closure is as follows: (\$000)

	<u>Contractual Facility Costs</u>	<u>Equipment Disposal</u>	<u>Total</u>
Balance December 31, 2003	\$ 4,119	\$ 411	\$ 4,530
2004 Charges	584	--	584
Uses	<u>(1,654)</u>	<u>(51)</u>	<u>(1,705)</u>
Balance December 31, 2004	3,049	360	3,409
2005 Charges	--	--	--
Uses	<u>(1,234)</u>	<u>--</u>	<u>(1,234)</u>
Balance September 30, 2005	<u>\$ 1,815</u>	<u>\$ 360</u>	<u>\$ 2,175</u>

Of the \$2.2 million in accrued restructuring costs, \$2.0 million has been classified as other current liabilities and \$154,000 has been classified as other long-term obligations as of September 30, 2005. These restructuring costs are expected to be paid in cash over the remaining facility lease term, which expires in October 2006. Actual future costs or actual sublease income may be different than these estimates and could require an adjustment to the restructuring accrual in the period such determination is made.

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

Overview

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, as amended and Section 21E of the Securities Exchange Act of 1934, as amended, including statements regarding the Company's expectations, hopes, intentions or strategies regarding the future. Forward-looking statements include, but are not limited to: statements regarding future revenues and dependence on standard products sales and international sales; statements regarding the levels of international sales; statements regarding future products or product development; statements regarding future research and development spending and the Company's product development strategy; statements regarding future expansion or utilization of manufacturing capacity; statements regarding future expenditures; statements regarding current or future acquisitions; and statements regarding our ability to meet our anticipated short term and long term cash requirements; and statements regarding the future realization of tax benefits. In some cases, forward-looking statements can be identified by the use of forward-looking terminology such as "believe," "estimate," "may," "can," "will," "could," "would," "intend," "objective," "plan," "expect," "likely," "potential," "possible" or "anticipate" or the negative of these terms or other comparable terminology. 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. These statements are subject to risks and uncertainties that could cause actual results and events to differ materially from those expressed or implied by 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, 2004.

Micrel designs, develops, manufactures and markets a range of high-performance analog power integrated circuits ("ICs"), mixed-signal and digital ICs. 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's 2004 revenues grew to the highest level since 2000, increasing 22 percent over 2003. The increase in customer demand in the first half of 2004 caused lead times for semiconductor components, including Micrel's, to expand during the first and second quarters of 2004 as customers and distributors became concerned about availability of supply. The Company's revenues continued to grow in the first half of the year and gross margin, operating margin and net income increased on a sequential basis in both the first and second quarters. By the end of the second quarter, customers began to perceive that the supply of semiconductor components was generally sufficient and lead times for certain components began to shrink.

In the third and fourth quarter of 2004, demand was below normal seasonal levels as customers reacted quickly to uncertain demand for their products, decreasing semiconductor lead times and uncertain economic conditions by reducing their order rates. Customers in certain end markets such as networking, enterprise computing and high speed communications experienced lower demand for their end products than they had anticipated. This factor, combined with rapidly shrinking lead times from most semiconductor suppliers, led to lower order rates for the Company's products in the second half of 2004 as customers attempted to control their inventory levels. The Company's level of on hand inventory remained above prior year levels to provide a high level of customer service in response to shorter customer lead times. As a result of lower order rates, the Company's backlog and revenues declined in both the third and fourth quarter of 2004.

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

In the first quarter of 2005, demand as measured by order rates, improved substantially over fourth quarter of 2004 levels. First quarter bookings increased by 40% over fourth quarter 2004 levels. The improvement in order rates was driven by customers serving the industrial, computing and communications end markets. Orders from customers serving the wireless handset end market were slightly less than fourth quarter levels, which is normal for the first calendar quarter. Bookings from Micrel's major distributors increased in the first quarter after falling sharply in the second half of 2004 as distributors adjusted to shorter industry lead times and reduced their inventory levels. Despite increased bookings during the first quarter and lean supply chain inventory levels, order lead times from our customers continued to average two to three weeks. Despite relatively flat revenues, the Company continued to improve gross margin. First quarter of 2005 gross margin of 50.1% was the highest quarterly gross margin for Micrel since the first quarter of 2001. First quarter of 2005 gross margin improved by 3.8% from the fourth quarter of 2004 and was more than 5% higher than the year ago period on approximately the same level of revenues. Operating profit and net income in the first quarter of 2005 also increased from both the first and fourth quarters of 2004.

In the second quarter of 2005, the ongoing short lead time environment continued to motivate customers to order only what was required for their short term needs. Second quarter order rates declined from first quarter levels primarily due to lower order amounts from the Company's distributors and certain customers serving the wireless handset end market. Bookings from the Company's major sell-through distributors declined from strong first quarter levels and were less than overall resales for the second quarter as our distributors attempted to increase their inventory turns to improve their return on working capital. Inventories at the Company's Asia-based stocking representatives also declined sequentially in second quarter. In the wireless handset market, customers reduced both orders and production levels in coordination with efforts to reduce channel inventories of handsets.

Second quarter revenues increased sequentially by 2% but were 10% below the revenues of the year ago period. The Company continued to exercise pricing discipline for most of its products in an attempt to improve gross profit. Consequently, sales of certain products, such as those serving the SOHO Ethernet market and the low end personal computer market, declined resulting in a lower rate of revenue growth for the Company. Gross margin continued to improve in the second quarter, increasing to 52% from 49% in the year ago period and 50% in the first quarter of 2005. The increase in gross margin was primarily due to: better pricing discipline, improved sales mix of higher margin products, ongoing manufacturing cost reductions and lower depreciation expense as a result of disciplined capital spending.

Third quarter order rates increased substantially from second quarter levels, increasing sequentially in all geographic regions. Throughout the third quarter customers continued to place orders with extremely short delivery requirements, even as the aggregate order level increased. Order levels from our distributors increased in the third quarter, returning to a level consistent with sales of Micrel's products to their end customers. Inventories at the Company's Asia-based stocking representatives declined sequentially in third quarter. Third quarter revenues increased sequentially by 1% but were 8% below the revenue level of the year ago period. Although order rates were strong, third quarter revenue growth was impacted by product shortages for our Ethernet products due to longer manufacturing cycle times at third party wafer suppliers and reduced demand for certain commodity products possibly as a result of continued pricing discipline. Gross margin improved further in the third quarter, increasing to 54% from 48% in the year ago period and 52% in the second quarter. The increase in gross margin is primarily attributed to an improved sales mix of higher margin products and ongoing manufacturing cost reductions. Micrel has significantly improved gross margin through the first three quarters of 2005 while continuing to operate its wafer fabrication facility at approximately 50% of equipped utilization. Year-to-date gross margin of 52% is 4% higher than the first nine months of 2004, although year-to-date revenues in 2005 are approximately \$13 million lower than 2004.

In March 2004, Micrel completed the acquisition of BlueChip Communications AS ("BlueChip") of Oslo, Norway. BlueChip is a fabless semiconductor company that designs, develops and markets high performance RF ICs and modules for the actuation and connectivity markets. The acquisition was accounted for as a purchase under SFAS No. 141 "Business Combinations" and, accordingly, the results of operations of BlueChip from the date of acquisition forward have been included in the Company's consolidated financial statements.

The Company derives a substantial portion of its net revenues from standard products. For the three and nine month periods ended September 30, 2005 and 2004 the Company's standard products sales accounted for 95% and 96% of the Company's net revenues, respectively. The Company believes that a substantial portion of its net revenues

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

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 and Estimates

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 of America. 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 judgments. Management bases its estimates and judgments 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. The Company considers certain accounting policies related to revenue recognition, inventory valuation, income taxes, and litigation to be critical to the fair presentation of its financial statements. 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, 2004.

Revenue Recognition and Receivables. 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 or determinable and collection of the resulting receivable is reasonably assured.

Micrel allows certain distributors, primarily located in North America and Europe, and in certain countries in Asia, significant return rights, price protection and pricing adjustments subsequent to the initial product shipment. As these returns and price concessions have historically been significant, and future returns and price concessions are difficult to reliably estimate, the Company 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. Although revenue recognition and related cost of sales are deferred, the Company records an accounts receivable and relieves inventory at the time of initial product shipment. As standard terms are FOB shipping point, payment terms are enforced from shipment date and legal title and risk of inventory loss passes to the distributor upon shipment. In addition, the Company may offer to its distributors, where revenue is deferred upon shipment and recognized on a sell-through basis, price adjustments to allow the distributor to price the Company's products competitively for specific resale opportunities. The Company estimates and records an allowance for distributor price adjustments for which the specific resale transaction has been completed, but the price adjustment claim has not yet been received and recorded by the Company.

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

Sales to OEM customers and Asian based stocking representatives are recognized upon shipment. The Company does not grant return rights, price protection or pricing adjustments to OEM customers. The Company offers limited contractual stock rotation rights to stocking representatives. In addition, the Company is not contractually obligated to offer, but may infrequently grant, price adjustments or price protection to certain stocking representatives on an exception basis. At the time of shipment to OEMs and stocking representatives, an allowance for returns is established based upon historical return rates, and an allowance for price adjustments is established based on an estimate of price adjustments to be granted. Actual future returns and price adjustments could be different than the allowance established.

The Company also maintains an allowance for doubtful accounts for estimated uncollectible accounts receivable. 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 records 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 SEC Staff Accounting Bulletin 100 "Restructuring and Impairment Charges."

Income Taxes. Deferred tax assets and liabilities result 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 must regularly assess the likelihood that future taxable income levels will be sufficient to ultimately realize the tax benefits of these deferred tax assets. As of September 30, 2005, 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. Should the Company determine that future realization of these tax benefits is not likely, a valuation allowance would be established, which would increase the Company's tax provision in the period of such determination.

In addition, the calculation of the Company's tax liabilities involves dealing with uncertainties in the application of complex tax regulations. The Company records liabilities for anticipated tax audit issues based on its estimate of whether, and the extent to which, additional taxes may be due. Actual tax liabilities may be different than the recorded estimates and could result in an additional charge or benefit to the tax provision in the period when the ultimate tax assessment is determined.

Litigation. The semiconductor industry is characterized by frequent litigation regarding patent and other intellectual property rights. The Company is currently involved in such intellectual property litigation (see Note 10 of Notes to Condensed Consolidated Financial Statements) and has not accrued a 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.

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

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,	
	2005	2004	2005	2004
Net revenues	100.0%	100.0%	100.0%	100.0%
Cost of revenues	45.9	51.0	48.0	52.0
Gross profit	54.1	49.0	52.0	48.0
Operating expenses:				
Research and development	18.2	16.4	18.4	15.8
Selling, general and administrative	18.4	14.7	17.0	13.8
Amortization of deferred stock compensation	0.2	0.7	0.3	0.9
Purchased in-process technology	-	-	-	0.2
Restructuring expense	-	0.6	-	0.2
Litigation accrual	-	-	5.0	-
Total operating expenses	36.8	32.4	40.7	30.9
Income from operations	17.3	16.6	11.3	17.1
Other income, net	1.7	0.5	1.6	0.4
Income before income taxes	19.0	17.1	12.9	17.5
Provision for income taxes	6.6	6.0	4.5	4.3
Net income	12.4%	11.1%	8.4%	13.2%

Net Revenues. For the three months ended September 30, 2005, net revenues decreased 8% to \$62.5 million from \$67.9 million for the same period in the prior year. For the nine months ended September 30, 2005, net revenues decreased 7% to \$185.2 million from \$198.1 million for the same period in the prior year. These decreases were primarily due to decreased standard products revenues.

Standard products revenues for the three months ended September 30, 2005 decreased 9% to \$59.5 million from \$65.3 million for the same period in the prior year. For the nine months ended September 30, 2005, standard products revenues decreased 7% to \$177.7 million from \$190.1 for the same period in the prior year. These decreases resulted primarily from decreased unit shipments of standard products to the computer products, industrial and network communications end markets.

Custom and foundry products revenues for the three months ended September 30, 2005 increased 17% to \$2.9 million from \$2.5 million for the same period in the prior year. For the nine months ended September 30, 2005, custom and foundry products revenues decreased 6% to \$7.5 million from \$8.0 million for the same period in the prior year.

Customer demand for semiconductors can change quickly and unexpectedly. 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 quarter. Within the semiconductor industry these orders that are booked and shipped within the quarter are called "turns fill" orders. When the turns fill level exceeds approximately 35% of quarterly revenue, it makes it very difficult to predict near term revenues and income. Because of the long cycle time to build its products, the Company's lack of visibility into demand when turns fill is high makes it difficult to predict what product to build to match future demand.

Although overall semiconductor industry channel inventories appear to be equal to or below long term historical trends, customers continue to place orders as if semiconductor components are readily available. Customers are cautious in committing new orders, relying instead on short lead times and the willingness of semiconductor manufacturers to hold inventory and react quickly to supply their short term needs. As a result, order lead times from the Company's customers remained in the two to three week range in the third quarter of 2005. The corresponding low backlog level, increased reliance on turns fill orders, and the uncertain growth rate of the world economy make it difficult to predict near term demand. The uncertainty in demand arising from these factors, together with the effects

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

of product mix and pricing, make it difficult to precisely predict future levels of sales and profitability. In this environment the Company, its stocking representatives and distributors may have to carry higher levels of inventory to service anticipated customer demand.

International sales represented 74% and 77% of net revenues for the three months ended September 30, 2005 and 2004, respectively. For the nine months ended September 30, 2005 and 2004, international sales represented 75% and 76% of net revenues, respectively.

The trend for the Company's customers to move their electronics manufacturing to Asian countries has brought increased pricing pressure for Micrel and other semiconductor manufacturers. Asian based manufacturers are typically more concerned about cost and less concerned about the capability of the integrated circuits they purchase. This can make it more difficult for United States based companies to differentiate themselves except by price. The increased concentration of electronics procurement and manufacturing in the Asia Pacific region has led, and may continue to lead, to continued price pressure for the Company's products in the future.

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. The Company's gross margin increased to 54% for the three months ended September 30, 2005 from 49% for the comparable period in 2004. For the nine months ended September 30, 2005, gross margin increased to 52% from 48% for the comparable period in 2004. These increases in gross margin resulted primarily from an increased sales mix of higher margin products combined with decreased depreciation and other manufacturing cost reductions. In addition, the second quarter of 2004 included a benefit of \$1.1 million from the reversal of accrued payroll tax liabilities associated with the conclusion of a tax audit (see Note 12 of Notes to Condensed Consolidated Financial Statements). Depreciation and amortization (excluding amortization of deferred stock compensation) as a percent of sales declined to 8% for the three and nine months ended September 30, 2005 from 9% for the same periods in 2004. This reduction in depreciation was primarily due to existing equipment becoming fully depreciated, which was partially offset by additional depreciation on new equipment purchases.

Research and Development Expenses. Research and development expenses as a percentage of net revenues represented 18% and 16%, for the three months ended September 30, 2005 and 2004, respectively. On a dollar basis, research and development expenses increased \$192,000 or 2% to \$11.4 million for the three months ended September 30, 2005 from \$11.1 million for the comparable period in 2004. For the nine months ended September 30, 2005 and 2004, research and development expenses represented 18% and 16% as a percentage of net revenues, respectively. On a dollar basis, research and development expenses increased \$2.6 million or 8% to \$34.0 million for the nine months ended September 30, 2005 from \$31.4 million for the comparable period in 2004. The second quarter of 2004 included a benefit of \$1.7 million from the reversal of accrued payroll tax liabilities associated with the conclusion of a tax audit (see Note 12 of Notes to Condensed Consolidated Financial Statements). 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 18% and 15% for the three months ended September 30, 2005 and 2004, respectively. On a dollar basis, selling, general and administrative expenses increased \$1.6 million or 16% to \$11.5 million for the three months ended September 30, 2005 from \$10.0 million for the comparable period in 2004. For the nine months ended September 30, 2005 and 2004, selling, general and administrative expenses represented 17% and 14% as a percentage of net revenues, respectively. On a dollar basis, selling, general and administrative expenses increased \$4.2 million or 15% to \$31.6 million for the nine months ended September 30, 2005 from \$27.4 million for the comparable period in 2004. These dollar increases were principally attributable to increased outside legal costs. In addition, the second quarter of 2004 included a benefit of \$1.1 million from the reversal of accrued payroll tax liabilities associated with the conclusion of a tax audit. (see Note 12 of Notes to Condensed Consolidated Financial Statements).

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 ("APB") No. 25, "Accounting for Stock Issued to Employees". During the years 1996 through December 2001, certain of the

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

Company's option pricing practices resulted in stock compensation expense under APB 25. As of September 30, 2005 total unamortized stock compensation was \$415,000 with an anticipated remaining future amortization schedule of \$120,000 in 2005.

In December 2004, the Financial Accounting Standards Board ("FASB" or the "Board") issued Statement of Accounting Standards ("SFAS") No. 123R, "Share-Based Payment". SFAS No. 123R is a revision of SFAS No. 123, and supersedes APB 25 (see Note 2 of Notes to Condensed Consolidated Financial Statements for more discussion of SFAS No. 123R).

Purchased In-process Technology. Associated with the acquisition of BlueChip, Micrel allocated \$2.6 million of the total purchase cost to intangible assets. Of that amount, \$480,000 was expensed for purchased in-process technology, which had not reached technological feasibility and had no alternative future use, in the three months ended March 31, 2004. This amount was adjusted and reversed in part as of December 31, 2004 to reflect the final determination of conditional consideration that had previously been allocated in part to purchased in-process technology.

Litigation Accrual. On July 22, 2005, a jury ruled against Micrel in its suit against TRW Automotive and for TRW automotive in its counter suit against Micrel. The suits were related to a contract dispute between the two companies. As a result of the jury's verdict, Micrel accrued \$9.3 million in litigation expense in the second quarter 2005 financial statements (see Note 10 of Notes to Condensed Consolidated Financial Statements).

Other Income, Net. Other income, net reflects interest income from investments in short-term and long-term investment grade securities and money market funds and other non-operating income, offset by interest expense incurred on term notes and accrued interest related to accrued litigation liabilities. Other income, net increased \$705,000 to \$1.1 million for the three months ended September 30, 2005 from \$363,000 for the comparable period in 2004. Other income, net increased \$2.0 million to \$2.9 million for the nine months ended September 30, 2005 from \$901,000 for the comparable period in 2004. The increase was primarily due to an increase in average interest rates and returns on investment balances and decreased interest expense resulting from a decrease in average debt.

Provision for Income Taxes. The income tax provision for the three and nine months ended September 30, 2005 represented 35% of pretax income. The income tax provision for the three and nine months ended September 30, 2004 represented 35% of pretax income, reduced by a \$3.8 million reversal of accrued income tax liabilities as a result of the completion of a federal income tax audit (see Note 12 of Notes to Condensed Consolidated Financial Statements) and increased by \$168,000 as a result of \$480,000 of non-deductible purchased in-process technology charges recorded in the quarter ended March 31, 2004. The income tax provision for such interim periods reflects the Company's estimated annual income tax rate and differs from taxes computed at the federal statutory rate primarily due to the effect of state income taxes, state research and development credits, federal extraterritorial income exclusion and federal qualified production activity deductions.

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, 2005, consisted of cash and short-term investments of \$140.8 million and a \$6 million revolving line of credit from a commercial bank (see Note 6 of Notes to Condensed Consolidated Financial Statements).

The Company generated \$38.0 million in cash flows from operating activities for the nine months ended September 30, 2005, primarily attributable to net income of \$15.5 million plus additions for non-cash activities of \$14.4 million and a \$7.0 million decrease in inventories combined with a \$7.0 million increase in other accrued liabilities, which were partially offset by a \$3.9 million increase in accounts receivable.

For the nine months ended September 30, 2004, the Company generated \$52.8 million in cash flows from operating activities, primarily attributable to net income of \$26.2 million plus additions for non-cash activities of

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

\$31.7 million and a \$4.7 million increase in accounts payable, which was partially offset by a \$5.4 million increase in accounts receivables and a \$5.9 million increase in inventories.

The Company generated \$1.6 million of cash from investing activities during the nine months ended September 30, 2005 comprised of \$12.1 million in proceeds from net sales of short-term investments that were partially offset by \$10.5 million in purchases of property, plant and equipment.

For the nine months ended September 30, 2004, the Company used \$54.8 million in cash for investing activities consisting of \$13.6 million in purchases of property, plant and equipment, \$38.3 million in purchases of short term and long-term investments, \$2.0 million for the purchase of BlueChip Communications and \$1.0 million for the purchase of intangible assets.

The Company used \$36.6 million of cash in financing activities during the nine months ended September 30, 2005 primarily for the repurchase of \$42.8 million of the Company's common stock, which was partially offset by \$6.3 million in proceeds from employee stock transactions.

For the nine months ended September 30, 2004, the Company used \$25.7 million of cash in financing activities primarily for the repurchase of \$29.0 million of the Company's common stock, which was partially offset by \$3.9 million in proceeds from employee stock transactions.

The Company currently intends to spend approximately \$15 million to \$20 million to purchase capital equipment and make facility improvements during the next twelve months primarily for manufacturing equipment for wafer fabrication and product testing and additional research and development related software and equipment. In March 2005, the Company announced that its Board of Directors had approved a \$75 million stock repurchase program and the Company is currently authorized by its Board of Directors to repurchase an additional \$32.2 million of its common stock through December 31, 2005. Since inception, the Company's principal sources of funding have been its cash from operations, bank borrowings and sales of common stock. The Company believes that its cash from operations, existing cash balances and short-term investments, and its credit facility will be sufficient to meet its cash requirements for 2005. In the longer term, the Company believes future cash requirements will continue to be met by its cash from operations, credit arrangements and future debt or equity financings as required.

Recently Issued Accounting Standards

Please refer to Note 2 of Notes to Condensed Consolidated Financial Statements for a discussion of the expected impact of recently issued accounting standards.

Contractual Obligations and Commitments

As of September 30, 2005, the Company had the following contractual obligations and commitments (in thousands):

	<u>Total</u>	<u>Payments Due By Period</u>			
		<u>Less than 1 Year</u>	<u>1-3 Years</u>	<u>4-5 Years</u>	<u>After 5 Years</u>
Long-term debt	\$ 153	\$ 153	\$ —	\$ —	\$ —
Operating leases	9,037	3,146	2,699	2,503	689
Open purchase orders	<u>23,000</u>	<u>23,000</u>	<u>—</u>	<u>—</u>	<u>—</u>
Total	<u>\$ 32,190</u>	<u>\$ 26,299</u>	<u>\$ 2,699</u>	<u>\$ 2,503</u>	<u>\$ 689</u>

Open purchase orders are defined as agreements to purchase goods or services that are enforceable and legally binding and that specify all significant terms, including: fixed or minimum quantities to be purchased; fixed, minimum or variable pricing provisions; and the approximate timing of the transactions.

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

Borrowing agreements consisted of a \$5 million revolving line of credit from a commercial bank. The revolving line of credit agreement includes a provision for the issuance of commercial or standby letters of credit by the bank on behalf of the Company. The value of all letters of credit outstanding reduces the total line of credit available. There were no borrowings under the revolving line of credit at September 30, 2005 and there were \$875,000 in standby letters of credit outstanding. The letters of credit are issued to guarantee payments for the Company's workers compensation program.

The Company has no other off-balance sheet arrangements and has not entered into any transactions involving unconsolidated, limited purpose entities or commodity contracts.

Factors That May Affect Operating Results

If a company's operating results are below the expectations of public market analysts or investors, then the market price of its common stock could decline. Many factors that can affect a company's quarterly and annual results are difficult to control or predict. Some of the factors which can affect a multinational semiconductor business such as the Company are described below. Additional factors that may affect the Company and its operating results are contained within the Company's Form 10-K for the year ended December 31, 2004.

Geopolitical and Macroeconomic Risks That May Affect Multinational Enterprises

Demand for semiconductor components is increasingly dependent upon the rate of growth of the global economy. If the rate of global economic growth slows, or contracts, customer demand for products could be adversely affected, which in turn could negatively affect revenues, results of operations and financial condition. Many factors could adversely affect regional or global economic growth. Some of the factors that could slow global economic growth include: increased price inflation for goods, services or materials, rising interest rates in the United States, a slowdown in the rate of growth of the Chinese economy, a significant act of terrorism which disrupts global trade or consumer confidence, geopolitical tensions including war and civil unrest. Reduced levels of economic activity, or disruptions of international transportation, could adversely affect sales on either a global basis or in specific geographic regions.

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. In 2004 and the first nine months of 2005, 66% of the Company's revenues were derived from shipments to customers in Asia, an increase from 32% in 2000 and 60% in 2003. International markets are subject to a variety of risks, including changes in policy by the U.S. or foreign governments, acts of terrorism, foreign government instability, 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. 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. 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 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.

Market conditions may lead the Company to initiate additional cost reduction plans, which may negatively affect near term operating results. Weak customer demand, competitive pricing pressures, excess capacity, weak economic conditions or other factors, may cause the Company 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.

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

Semiconductor Industry Specific Risks

The volatility of customer demand in the semiconductor industry limits a company's ability to predict future levels of sales and profitability. Semiconductor suppliers can rapidly increase production output, leading 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 products can result in excess quantities of certain 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 Company's quarterly revenues are highly dependent upon turns fill orders (orders booked and shipped in the same quarter). The short-term and volatile nature of customer demand makes it extremely difficult to accurately predict near term revenues and profits.

The short lead time environment in the semiconductor industry has allowed many end consumers to rely on stocking representatives and distributors to carry inventory to meet short term requirements and minimize their investment in on-hand inventory. The Company maintains a network of stocking representatives and distributors, that carry inventory to service the volatile short-term demand of the end customer. Should the relationship with a distributor or stocking representative be terminated, the 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 and subject to rapid technological change, price-erosion and increased international competition. Significant competitive factors include product features, performance and price; timing of product introductions; emergence of new computer and communications standards; quality and customer support.

Many semiconductor companies face risks associated with a dependence upon third parties that manufacture, assemble or package certain of its products. These risks include reduced control over delivery schedules and quality; inadequate manufacturing yields and excessive costs; the potential lack of adequate capacity during periods of excess demand; difficulties selecting and integrating new subcontractors; potential increases in prices; disruption in supply due to civil unrest, terrorism or other events which may occur in the countries in which the subcontractors operate; and 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.

During a period when economic growth and customer demand have been less certain, both the semiconductor industry and the Company have experienced significant price erosion since the beginning of 2001. If price erosion continues, it will have the effect of reducing revenue levels and gross margins in future periods. Furthermore, the trend for the Company's customers to move their electronics manufacturing to Asian countries has brought increased pricing pressure for Micrel and the semiconductor industry. Asian based manufacturers are typically more concerned about cost and less concerned about the capability of the integrated circuits they purchase. The increased concentration of electronics procurement and manufacturing in the Asia Pacific region may lead to continued price pressure and additional product advertising costs for the Company's products in the future.

An important part of the Company's strategy is to continue to focus on the market for high-speed communications ICs. If the recovery in the telecommunications infrastructure and wire line networking markets is not sustainable, resulting in reduced demand for the Company's high bandwidth products, the Company's future revenue growth and profitability could be adversely affected.

Our customers are requiring that the Company offer its products in lead-free packages. Governmental regulations in certain countries and our customers' intention to produce products that are less harmful to the environment has resulted in a requirement from many of the Company's customers to purchase integrated circuits that do not contain lead. The Company has responded by offering its products in lead-free versions. While the lead-free

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

versions of the Company's products are expected to be more friendly to the environment, the ultimate impact is uncertain. The transition to lead-free products may produce sudden changes in demand depending on the packaging method used, which may result in excess inventory of products packaged using traditional methods. This may have an adverse affect on the Company's results of operations. In addition, the quality, cost and manufacturing yields of the lead free products may be less favorable compared to the products packaged using more traditional materials which may result in higher costs to the Company.

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.

Because the standard products market for ICs 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. 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 significant investment in semiconductor manufacturing capacity and the rapid growth of circuit design centers in China may present a competitive threat to established semiconductor companies due to the current low cost of labor and capital in China. The emergence of low cost competitors in China could reduce the revenues and profitability of established semiconductor manufacturers.

There is intense competition for qualified personnel in the semiconductor industry, in particular design engineers. 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 success of companies in the semiconductor industry depends in part upon 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 frequent 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 recently issued Statement of Accounting Standards ("SFAS") No. 123R, "Share-Based Payment" will require the Company to recognize the cost of employee services received in exchange for awards of equity instruments, based on the grant date fair value of those awards, in the financial statements. As discussed in Note 2 of Notes to Condensed Consolidated Financial Statements, the ultimate impact from the adoption of this accounting standard is uncertain but it is expected to significantly increase stock based compensation expense in future periods after adoption. The pro forma effect to net income and earnings per share had the Company applied the fair value method to stock-based awards has been disclosed in the Company's previous Form 10-K filings and is contained in Note 1 of the Notes to Condensed Consolidated Financial Statements of this Form 10-Q. However, a reduction in net income and earnings per share from the expensing of stock option awards in the Company's future results of operation may have an adverse affect on the value of the Company's common stock. If the Company reduces the number of stock option grants to

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

employees to minimize the cost associated with share based incentive awards, it will most likely make it more difficult for the Company to hire and retain employees.

Companies in the semiconductor industry are 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 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 the Company 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.

Company-Specific Risks

In addition to the risks that affect multinational semiconductor companies listed above, there are additional risks which are more specific to the Company such as:

The Company's gross margin, operating margin and net income are highly dependent on the level of revenue and capacity utilization that the Company experiences. 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 profit margins.

The cellular telephone (wireless handset) market comprises a significant portion of the Company's standard product revenues. The proportion of the Company's annual revenues from customers serving the cellular telephone market has been increasing over the last three years, growing from less than 20% of worldwide sales in 2001 to approximately 25% in 2004 and 27% in the first nine months of 2005. Due to the highly competitive and fast changing environment in which the Company's cellular telephone customers operate, demand for the product the Company sells into this end market can change rapidly and unexpectedly. If the Company's cellular telephone customers lose market share, or accumulate too much inventory of completed handsets, the demand for the Company's products can decline sharply which could adversely affect the Company's revenues and results of operations.

The Company is currently involved in a number of lawsuits. The Company currently has four significant pending litigations. Litigation is by its nature unpredictable and costly. Two cases are currently scheduled for trial in the fourth quarter of 2005 and the first quarter of 2006, respectively, and the Company filed a Motion for an order setting aside the July 22, 2005 jury verdict in the Micrel vs. TRW case. The Company currently expects that outside legal expenses will continue to be significant through the first half of 2006. If the level of effort required to prosecute or defend the Company's position in any of the law suits increases significantly, or if a judgment is entered against the Company, the resulting expense could adversely affect the Company's results of operations or cash flows.

The Company derives a significant portion of its revenues from customers located in certain geographic regions or countries. A significant portion of the Company's revenues come from customers located in South Korea. In the event that political tensions surrounding North Korea evolve into military or social conflict, or other factors disrupt the Korean economy, the Company's revenues, results of operations, cash flow and financial condition could be adversely affected. A significant portion of the Company's revenues come from customers located in Taiwan and China. In the event that economic activity in these two countries declines, or is disrupted by geopolitical events, the Company's revenues and results of operations could be adversely affected.

The Company manufactures most of its semiconductors at its San Jose, California fabrication facilities. The Company's existing wafer fabrication facility, located in Northern California, 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. Furthermore, 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 ICs is a

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

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. The Company maintains approximately two to three months of inventory that has completed the wafer fabrication manufacturing process. This inventory is generally located offshore at third party subcontractors and can act to buffer some of the adverse impact from a disruption to the Company's San Jose wafer fabrication activity arising from a natural disaster such as an earthquake.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

At September 30, 2005, the Company held \$36.5 million in short-term investments. Short-term investments consist primarily of liquid debt instruments and are classified as available-for-sale securities. Investments purchased with remaining maturity dates of greater than three months and less than 12 months are classified as short-term. Investments purchased with remaining maturity dates of 12 months or greater are classified either as short-term or as long-term based on maturities and the Company's intent with regards to those securities (expectations of sales and redemptions). These available-for-sale securities are subject to interest rate risk and will fall in value if market interest rates increase. If market interest rates were to increase immediately and uniformly by 10 percent from levels at September 30, 2005, the fair value of the short-term investments would decline by an immaterial amount. The Company generally expects to have the ability to hold its fixed income investments until maturity and therefore would not expect operating results or cash flows to be affected to any significant degree by the effect of a sudden change in market interest rates on short-term investments.

At September 30, 2005, the Company held no fixed-rate long-term debt subject to interest rate risk.

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 period covered by this report. Based on the foregoing, the Company's chief executive officer and chief financial officer have concluded that the Company's disclosure controls and procedures are effective at the reasonable assurance level as of September 30, 2005.

There has been no change in the Company's internal control 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 control over financial reporting.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

The information included in Note 10 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. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

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.

Issuer Purchases of Equity Securities

<u>Period</u>	<u>Total Number of Shares Purchased</u>	<u>Average Price Paid Per Share</u>	<u>Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs</u>	<u>Maximum Dollar Value of Shares that May Yet be Repurchased Under the Plans or Programs (\$000)</u>
January 2005	478,500	\$ 9.19	478,500	\$ 31,216
February 2005	415,800	\$ 8.85	415,800	\$ 27,535
March 2005	943,900	\$ 9.61	943,900	\$ 57,852
April 2005	722,600	\$ 8.69	722,600	\$ 51,574
May 2005	507,600	\$10.30	507,600	\$ 46,348
June 2005	308,400	\$11.67	308,400	\$ 42,746
July 2005	254,600	\$12.35	254,600	\$ 39,601
August 2005	349,400	\$11.83	349,400	\$ 35,466
September 2005	<u>270,100</u>	<u>\$12.11</u>	<u>270,100</u>	<u>\$ 32,194</u>
Total	<u>4,250,900</u>	<u>\$10.07</u>	<u>4,250,900</u>	

In February 2002, the Company's Board of Directors approved a plan to repurchase shares of the Company's common stock in the open market. 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) plan. In August 2004, the Board of Directors amended the repurchase program and authorized the repurchase of common stock up to a maximum value of \$75 million during the period from January 1, 2004 through June 30, 2005. In March 2005, the Board of Directors approved a \$75 million share repurchase program for calendar year 2005. This action supercedes the Company's previously approved authorization to repurchase Micrel common stock announced in August, 2004.

ITEM 6. 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

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 8, 2005

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)) and internal control over financial reporting (as defined in the Exchange Act Rules 13a-15(d) and 15d-15(f)) 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) designed such internal control over financial reporting, or caused such internal control over financial control to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c) 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;
 - d) 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 8, 2005

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)) and internal control over financial reporting (as defined in the Exchange Act Rules 13a-15(d) and 15d-15(f)) 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) designed such internal control over financial reporting, or caused such internal control over financial control to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c) 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;
 - d) 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 8, 2005

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, 2005 (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 8, 2005

/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, 2005 (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 8, 2005

/s/ Richard D. Crowley, Jr.

Richard D. Crowley
Chief Financial Officer