
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: 0-21184

MICROCHIP TECHNOLOGY INCORPORATED

(Exact Name of Registrant as Specified in Its Charter)

Delaware
(State or Other Jurisdiction of
Incorporation or Organization)

86-0629024
(IRS Employer
Identification No.)

2355 W. Chandler Blvd., Chandler, AZ 85224-6199
(480) 792-7200

(Address, Including Zip Code, and Telephone Number,
Including Area Code, of Registrant's
Principal Executive Offices)

Indicate by checkmark 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 the filing requirements for the past 90 days.

Yes ☒ No ☐

Indicate by checkmark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Securities Exchange Act of 1934).

Yes ☐ No ☒

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Securities Exchange Act of 1934).

Yes ☐ No ☒

Number of shares of common stock, \$.001 par value, outstanding as of October 28, 2005: **210,181,097 shares.**

MICROCHIP TECHNOLOGY INCORPORATED AND SUBSIDIARIES

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MICROCHIP TECHNOLOGY INCORPORATED AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands, except share amounts)

	September 30, 2005 (Unaudited)	March 31, 2005 (Note 1)
ASSETS		
Cash and cash equivalents	\$ 110,080	\$ 68,730
Short-term investments	792,410	665,874
Accounts receivable, net	120,500	113,088
Inventories	110,226	103,728
Prepaid expenses	12,357	10,828
Deferred tax assets	90,600	105,097
Other current assets	9,046	8,003
Total current assets	1,245,219	1,075,348
Property, plant and equipment, net	662,592	693,302
Goodwill	31,886	31,886
Intangible assets, net	9,766	9,289
Other assets	8,632	7,729
Total assets	\$ 1,958,095	\$ 1,817,554
LIABILITIES AND STOCKHOLDERS' EQUITY		
Short-term debt	\$ 45,454	\$ 45,454
Accounts payable	32,629	34,328
Accrued liabilities	160,547	135,153
Deferred income on shipments to distributors	88,963	91,730
Total current liabilities	327,593	306,665
Pension accrual	561	599
Deferred tax liability	17,301	24,556
Stockholders' equity:		
Preferred stock, \$.001 par value; authorized 5,000,000 shares; no shares issued or outstanding.	—	—
Common stock, \$.001 par value; authorized 450,000,000 shares; issued and outstanding 210,072,909 shares at September 30, 2005; issued 208,556,546 and outstanding 207,738,214 shares at March 31, 2005.	210	208
Additional paid-in capital	557,873	532,666
Retained earnings	1,064,804	984,095
Deferred stock-based compensation	(735)	—
Accumulated other comprehensive loss	(9,512)	(9,718)
Less shares of common stock held in treasury at cost; 818,332 shares at March 31, 2005.	—	(21,517)
Net stockholders' equity	1,612,640	1,485,734
Total liabilities and stockholders' equity	\$ 1,958,095	\$ 1,817,554

See accompanying notes to condensed consolidated financial statements

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(in thousands, except per share amounts)

(Unaudited)

	Three Months Ended September 30,		Six Months Ended September 30,	
	2005	2004	2005	2004
Net sales	\$ 227,298	\$ 220,694	\$ 445,825	\$ 433,469
Cost of sales	92,742	94,317	183,764	185,633
Gross profit	<u>134,556</u>	<u>126,377</u>	<u>262,061</u>	<u>247,836</u>
Operating expenses:				
Research and development	23,637	23,318	47,032	46,599
Selling, general and administrative	31,624	28,008	62,705	55,232
Special charge	—	—	—	21,100
	<u>55,261</u>	<u>51,326</u>	<u>109,737</u>	<u>122,931</u>
Operating income	79,295	75,051	152,324	124,905
Other income (expense):				
Interest income	7,518	4,265	14,098	7,185
Interest expense	(505)	(207)	(938)	(343)
Other, net	77	421	1,198	1,386
	<u>86,385</u>	<u>79,530</u>	<u>166,682</u>	<u>133,133</u>
Income before income taxes	86,385	79,530	166,682	133,133
Income tax provision	<u>20,732</u>	<u>19,087</u>	<u>40,005</u>	<u>28,891</u>
Net income	\$ <u>65,653</u>	\$ <u>60,443</u>	\$ <u>126,677</u>	\$ <u>104,242</u>
Basic net income per common share	\$ <u>0.31</u>	\$ <u>0.29</u>	\$ <u>0.61</u>	\$ <u>0.50</u>
Diluted net income per common share	\$ <u>0.31</u>	\$ <u>0.29</u>	\$ <u>0.59</u>	\$ <u>0.49</u>
Dividends declared per common share	\$ <u>0.125</u>	\$ <u>0.046</u>	\$ <u>0.220</u>	\$ <u>0.086</u>
Weighted average common shares outstanding	<u>209,424</u>	<u>206,191</u>	<u>208,945</u>	<u>206,441</u>
Weighted average common and potential common shares outstanding	<u>214,688</u>	<u>211,403</u>	<u>214,128</u>	<u>212,089</u>

See accompanying notes to condensed consolidated financial statements

MICROCHIP TECHNOLOGY INCORPORATED AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(Unaudited)

	Six Months ended September 30,	
	2005	2004
Cash flows from operating activities:		
Net income	\$ 126,677	\$ 104,242
Adjustments to reconcile net income to net cash provided by operating activities:		
Gain on sale of fixed assets	(201)	(1,082)
Depreciation and amortization	56,021	60,841
Deferred income taxes	7,122	31,462
Stock-based compensation	85	—
Tax benefit from exercise of stock options	9,287	9,045
Changes in operating assets and liabilities:		
Increase in accounts receivable	(7,412)	(11,471)
(Increase) decrease in inventory	(6,498)	4,599
(Decrease) increase in deferred income on shipments to distributors	(2,767)	16,174
Increase (decrease) in accounts payable and accrued liabilities	24,595	(26,889)
Change in other assets and liabilities	(3,848)	(1,956)
Net cash provided by operating activities	<u>203,061</u>	<u>184,965</u>
Cash flows from investing activities:		
Purchases of short-term investments	(333,983)	(479,068)
Sales and maturities of short-term investments	207,773	315,347
Investment in other assets	(1,528)	—
Proceeds from sale of assets	544	1,083
Capital expenditures	<u>(25,166)</u>	<u>(34,060)</u>
Net cash used in investing activities	<u>(152,360)</u>	<u>(196,698)</u>

Cash flows from financing activities:		
Payment of cash dividend	(45,967)	(17,739)
Repurchase of common stock	—	(65,122)
Proceeds from short-term borrowings	—	42,275
Proceeds from sale of common stock	36,616	22,210
Net cash used in financing activities	(9,351)	(18,376)
Net increase (decrease) in cash and cash equivalents	41,350	(30,109)
Cash and cash equivalents at beginning of period	68,730	105,334
Cash and cash equivalents at end of period	\$ 110,080	\$ 75,225

See accompanying notes to condensed consolidated financial statements

MICROCHIP TECHNOLOGY INCORPORATED AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

(1) Basis of Presentation

The accompanying unaudited condensed consolidated financial statements include the accounts of Microchip Technology Incorporated and its wholly-owned subsidiaries (the “Company”). All intercompany balances and transactions have been eliminated in consolidation. We do not have any subsidiaries in which we do not own 100% of the outstanding stock.

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the United States of America, pursuant to the rules and regulations of the Securities and Exchange Commission (the “SEC”). In the opinion of management, all adjustments of a normal recurring nature which are necessary for a fair presentation have been included. Certain information and footnote disclosures normally included in audited consolidated financial statements have been condensed or omitted pursuant to such SEC rules and regulations. It is suggested that these condensed consolidated financial statements be read in conjunction with the audited consolidated financial statements and the notes thereto included in the Company’s Annual Report on Form 10-K for the year ended March 31, 2005. The results of operations for the three and six months ended September 30, 2005 are not necessarily indicative of the results that may be expected for the year ending March 31, 2006 or for any other period.

(2) Settlement with U.S. Philips Corporation

The Company reached an agreement with U.S. Philips Corporation and Philips Electronics North America Corp. (together “Philips”) regarding patent license litigation with Philips which was ongoing from October 2001. The agreement included dismissal of the then pending litigation and the cross-license of certain patents between Philips and the Company. The Company recorded a special charge of \$21.1 million in the quarter ended June 30, 2004 associated with this matter. Pursuant to this cross-license, the Company licensed certain of its patents related to 8-pin microcontrollers to Philips, and Philips licensed its patents related to I²C serial communications to the Company, each on fully-paid up, non-royalty bearing worldwide licenses. The Company finalized and executed the definitive settlement agreement related to this matter and made the cash payment to Philips during the quarter ended September 30, 2004.

(3) Share-Based Payment

The Company grants stock options for a fixed number of shares to certain employees and directors with an exercise price equal to the fair market value of the shares at the date of grant. The Company accounts for stock option grants in accordance with Accounting Principles Board Opinion (“APB”) No. 25, “Accounting for Stock Issued to Employees” and related Interpretations, and, accordingly, recognizes no compensation expense for the stock option grants.

The following table represents the effect on net income and earnings per share (shown in thousands except for per share amounts) if the Company had applied the fair value based method and recognition provisions of Statement of Financial Accounting Standards (“SFAS”) No. 123, “Accounting for Stock-Based Compensation,” to share-based employee and director compensation. For purposes of this pro forma disclosure, the value of the options is estimated using a Black-Scholes option pricing model and amortized ratably to expense over the options’ vesting periods. Because the estimated value is determined as of the date of grant, the actual value ultimately realized by the employee may be significantly different.

In light of recent regulatory guidance, the Company reevaluated the assumptions used to estimate the value of employee stock options granted in the first quarter of fiscal 2006, and management determined that a blend of implied volatility and historical volatility is more reflective of market conditions and a better indicator of expected volatility than using purely historical volatility. Management continued to use this volatility assumption in the second quarter of fiscal 2006.

	Three Months Ended September 30,		Six Months Ended September 30	
	2005	2004	2005	2004
Net income, as reported	\$ 65,653	\$ 60,443	\$ 126,677	\$ 104,242
Deduct: Total share-based employee compensation expense determined under fair value methods for all awards, net of related tax effects	4,395	7,819	9,337	15,265
Pro forma net income	\$ 61,258	\$ 52,624	\$ 117,340	\$ 88,977
Net income per common share:				
Basic as reported	\$ 0.31	\$ 0.29	\$ 0.61	\$ 0.50
Basic, pro forma	\$ 0.29	\$ 0.26	\$ 0.56	\$ 0.43

Diluted, as reported	\$	0.31	\$	0.29	\$	0.59	\$	0.49
Diluted, pro forma	\$	0.29	\$	0.25	\$	0.55	\$	0.42

During December 2004, the FASB issued SFAS No. 123R which requires companies to measure and recognize compensation expense for all share-based payments at fair value. Share-based payments include stock option grants. The Company grants options to purchase common stock to its employees and directors under its stock option plan at prices equal to the market value of the stock on the dates the options were granted. SFAS No. 123R is effective for the Company beginning April 1, 2006. Early adoption of the provisions of SFAS No. 123R is encouraged, but not required. The Company has not yet adopted this pronouncement and is currently evaluating the expected impact that the adoption of SFAS No. 123R will have on its consolidated financial position and results of operations. The Company expects the adoption of SFAS No. 123R will have an unfavorable impact on its consolidated results of operations and net income per common share. SFAS No. 123R also requires the benefits of tax deductions in excess of recognized compensation cost to be reported as a financing cash flow, rather than as an operating cash flow as required under current guidelines. This requirement will reduce the Company's net operating cash flows and increase net financing cash flows in periods after adoption. The Company cannot estimate what those amounts will be in the future because they depend on, among other things, when employees exercise stock options.

At a meeting held on February 17, 2005, the Compensation Committee of the Board of Directors and the Board of Directors of the Company approved the acceleration of the vesting of certain Company stock options with an option price of \$27.153 per share or greater. The purpose of the accelerated vesting was to enable the Company to avoid recognizing in its income statement compensation expense associated with these options in future periods, upon adoption of SFAS No. 123R (Share-Based Payment) in April 2006. The pre-tax charge to be avoided amounts to approximately \$13.7 million and represents the fair value of the unvested awards as of the date of the acceleration as determined under SFAS No. 123. This amount would otherwise have been required to be recognized as compensation expense over the vesting period upon adoption of SFAS No. 123R. As a result of the accelerated vesting, approximately 2.3 million option shares or 25.4% of the total number of the outstanding unvested option shares with varying remaining vesting schedules became immediately exercisable. In order to help avoid unintended personal benefits to the holders of the accelerated options, any shares received through the exercise of accelerated options may not be sold by the option holder until the first to occur of the original vesting date of the accelerated option or the termination of the employment of the option holder. In connection with the accelerated vesting, each option agreement underlying such options was amended. As of the date of the acceleration, the fair market value of the Company's common stock was below the option price of the accelerated options in all material respects, so no APB 25 charges were incurred and future potential charges are immaterial.

(4) Short-Term Investments

The Company's short-term investments are intended to establish a high-quality portfolio that preserves principal, meets liquidity needs, avoids inappropriate concentrations and delivers an appropriate yield in relationship to the Company's investment guidelines and market conditions. Short-term investments consist of corporate and various government agency and municipal debt securities. Management classifies the Company's short-term investments as available-for-sale. Available-for-sale securities are carried at fair value with unrealized

gains and losses reported in stockholders' equity. Realized gains and losses and declines in value judged to be other than temporary, if any, are included in operations. A decline in the market value of any available-for-sale security below cost that is deemed to be other than temporary, results in an impairment in the fair value of the investment. The impairment is charged to earnings and a new cost basis for the security is established. Premiums and discounts are amortized or accreted over the life of the related available-for-sale security. Dividend and interest income are recognized when earned. The cost of a security sold is calculated using the specific identification method. The following is a summary of available-for-sale securities at September 30, 2005 (amounts in thousands):

	Adjusted Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Government agency bonds	\$ 766,152	\$ —	\$ 11,290	\$ 754,862
Corporate preferred stock	34,975	—	—	34,975
Municipal bonds	2,604	—	31	2,573
	<u>\$ 803,731</u>	<u>\$ —</u>	<u>\$ 11,321</u>	<u>\$ 792,410</u>

During the three and six months ended September 30, 2005, the Company had gross realized losses on available-for-sale securities of eight thousand dollars. During the three and six months ended September 30, 2004, the Company did not have any gross realized gains or losses on sales of available-for-sale securities.

The amortized cost and estimated fair value of the available-for-sale securities at September 30, 2005 by maturity are shown below (amounts in thousands). Expected maturities can differ from contractual maturities because the issuers of the securities may have the right to prepay obligations without prepayment penalties, and the Company views its available-for-sale securities as available for current operations.

	Adjusted Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Available-for-sale				
Due in one year or less	\$ 220,861	\$ —	\$ 839	\$ 220,022
Due after one year and through five years	547,895	—	10,482	537,413
Due after five years through ten years	—	—	—	—
Due after ten years	34,975	—	—	34,975
	<u>\$ 803,731</u>	<u>\$ —</u>	<u>\$ 11,321</u>	<u>\$ 792,410</u>

(5) Accounts Receivable

Accounts receivable consists of the following (amounts in thousands):

	September 30, 2005	March 31, 2005
Trade accounts receivable	\$ 123,825	\$ 116,689
Other	413	216
	<u>124,238</u>	<u>116,905</u>
Less allowance for doubtful accounts	3,738	3,817
	<u>\$ 120,500</u>	<u>\$ 113,088</u>

(6) Inventories

The components of inventories consist of the following (amounts in thousands):

	September 30, 2005	March 31, 2005
Raw materials	\$ 3,687	\$ 4,852
Work in process	78,233	73,295
Finished goods	28,306	25,581
	<u>\$ 110,226</u>	<u>\$ 103,728</u>

Inventory impairment charges establish a new cost basis for inventory and charges are not subsequently reversed to income even if circumstances later suggest that increased carrying amounts are recoverable.

(7) Property, Plant and Equipment

Property, plant and equipment consists of the following (amounts in thousands):

	September 30, 2005	March 31, 2005
Land	\$ 47,212	\$ 45,641
Building and building improvements	364,262	356,233
Machinery and equipment	965,415	938,261
Projects in process	83,491	84,846
	<u>1,460,380</u>	<u>1,424,981</u>
Less accumulated depreciation and amortization	<u>797,788</u>	<u>731,679</u>
	<u>\$ 662,592</u>	<u>\$ 693,302</u>

Depreciation expense attributed to property and equipment was \$55.5 million in the six months ended September 30, 2005 and \$60.1 million in the six months ended September 30, 2004.

(8) Short-term Debt

The Company had short-term debt of \$45.5 million as of September 30, 2005. The short-term debt is a result of repurchase agreements that are in place with two investment brokerages used by the Company. The short-term debt is collateralized with \$47.5 million of the Company's short-term investments. The short-term debt had a weighted average interest rate of 3.8% as of September 30, 2005. The Company used these borrowings to fund the activity under its stock repurchase program beginning in the second quarter of fiscal 2005.

(9) Income Taxes

The income tax provision that the Company recorded in the six-month period ended September 30, 2004 was impacted by a special charge. There were no special charges in the three and six-month period ended September 30, 2005 or the three-month period ended September 30, 2004. The following table displays the impact that the special charge had on the income tax provision that the Company recorded in the six-month period ended September 30, 2004 (amounts in thousands):

	Six Months Ended September 30, 2004
Income before income taxes	\$ 133,133
Special charge:	
Philips settlement	<u>21,100</u>
Total special charge	21,100
Income before taxes excluding special charge	154,233
Effective tax rate	<u>24.0%</u>
Income tax provision excluding effect of special charge	37,015
Tax expense of special charge at 38.5%	8,124
Income tax provision	<u>\$ 28,891</u>

The special charge incurred during the six-month period ended September 30, 2004 was associated with a settlement with Philips regarding a litigation matter. Such charge was incurred in the U.S. and tax effected at the Company's applicable U.S. federal and state rate of 38.5%.

(10) Comprehensive Income

Comprehensive income consists of net income and net unrealized gains (losses) on available-for-sale investments. The components of other comprehensive income (loss) and related tax effects were as follows:

Three Months Ended September 30,		Six Months Ended September 30,	
2005	2004	2005	2004

Change in unrealized gains on investments, net of tax effect of \$739, (\$767), (\$120) and \$396, respectively	\$ (4,019)	\$ 4,587	\$ 206	\$ (1,906)
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(11) Net Income Per Share

The following table sets forth the computation of basic and diluted net income per share (in thousands, except per share amounts):

	Three Months Ended September 30,		Six Months Ended September 30,	
	2005	2004	2005	2004
Net income	\$ 65,653	\$ 60,443	\$ 126,677	\$ 104,242
Weighted average common shares outstanding	209,424	206,191	208,945	206,441
Dilutive effect of stock options	5,264	5,212	5,183	5,648
Weighted average common and potential common shares outstanding	214,688	211,403	214,128	212,089
Basic net income per common share	\$ 0.31	\$ 0.29	\$ 0.61	\$ 0.50
Diluted net income per common share	\$ 0.31	\$ 0.29	\$ 0.59	\$ 0.49

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(12) Stock Repurchase

On April 22, 2004, the Company announced that its Board of Directors had authorized the Company to purchase up to 2.5 million shares of its common stock in the open market or in privately negotiated transactions. As of September 30, 2005, the Company had repurchased 884,900 shares under this authorization. As of September 30, 2005, all of the purchased shares were used to fund stock option exercises and purchases under the Company's employee stock purchase plan. The timing and amount of future repurchases will depend upon market conditions and corporate considerations.

(13) Dividends

On October 28, 2002, the Company announced that its Board of Directors had approved and instituted a quarterly cash dividend on its common stock. A quarterly cash dividend of \$0.125 per share was paid on September 1, 2005 in the aggregate amount of \$26.2 million. A quarterly cash dividend of \$0.16 per share was declared on October 20, 2005 and will be paid on November 18, 2005 to shareholders of record as of November 3, 2005. The Company expects the December 2005 payment of its quarterly cash dividend to be approximately \$33.6 million.

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

Our Management's Discussion and Analysis of Financial Condition and Results of Operations contains certain forward-looking statements that involve risks and uncertainties, including statements regarding our strategy, financial performance and revenue sources. We use words such as "anticipate," "believe," "plan," "expect," "future," "intend" and similar expressions to identify forward-looking statements. Our actual results could differ materially from the results anticipated in these forward-looking statements as a result of certain factors including those set forth below and under "Additional Factors That May Affect Our Results of Operations," beginning at page 25. Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance or achievements. You should not place undue reliance on these forward-looking statements. We disclaim any obligation to update information contained in any forward-looking statement.

We begin our Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A) with a summary of Microchip's overall business strategy to give the reader an overview of the goals of our business and the overall direction of our business and products. This is followed by a discussion of the Critical Accounting Policies and Estimates that we believe are important to understanding the assumptions and judgments incorporated in our reported financial results. We then discuss our Results of Operations for the three and six months ended September 30, 2005 compared to the three and six months ended September 30, 2004. We then provide an analysis of changes in our balance sheet and cash flows, and discuss our financial commitments in sections titled "Liquidity and Capital Resources," "Contractual Obligations" and "Off-Balance Sheet Arrangements."

Strategy

Our goal is to be a worldwide leader in providing specialized semiconductor products for a wide variety of embedded control applications. Our strategic focus is on embedded control products, which include microcontrollers, high-performance linear and mixed signal devices, power management and thermal management devices, and complementary microperipheral products including interface devices, Serial EEPROMs, and our patented KEELOQ security devices. We provide highly cost-effective embedded control products that also offer the advantages of small size, high performance, low voltage/low power operation and ease of development, enabling timely and cost-effective embedded control product integration by our customers.

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Our manufacturing operations include wafer fabrication and assembly and test. The ownership of our manufacturing resources is an important component of our business strategy, enabling us to maintain a high level of manufacturing control resulting in us being one of the lowest cost producers in the embedded control industry. By owning our wafer fabrication facilities and much of our assembly and test operations, and by employing statistical process control techniques, we have been able to achieve and maintain high production yields. Direct control over manufacturing resources allows us to shorten our design and production cycles. This control also allows us to capture the wafer manufacturing and a portion of the assembly and test profit margin.

We employ proprietary design and manufacturing processes in developing our embedded control products. We believe our processes afford us both cost-effective designs in existing and derivative products and greater functionality in new product designs. While many of our competitors develop and optimize separate processes for their

logic and memory product lines, we use a common process technology for both microcontroller and non-volatile memory products. This allows us to more fully leverage our process research and development costs and to deliver new products to market more rapidly. Our engineers utilize advanced computer-aided design (CAD) tools and software to perform circuit design, simulation and layout, and our in-house photomask and wafer fabrication facilities enable us to rapidly verify design techniques by processing test wafers quickly and efficiently.

We are committed to continuing our investment in new and enhanced products, including development systems, and in our design and manufacturing process technologies. We believe these investments are significant factors in maintaining our competitive position. Our current research and development activities focus on the design of new microcontrollers, digital signal controllers, ASSPs, memory and mixed-signal products, new development systems, software and application-specific software libraries. We are also developing new design and process technologies to achieve further cost reductions and performance improvements in existing products.

We market our products worldwide primarily through a network of direct sales personnel and distributors. Our distributors focus primarily on servicing the product and technical support requirements of a broad base of diverse customers. We believe that distributors provide an effective means of reaching this broad and diverse customer base. Our direct sales force focuses primarily on major strategic accounts in three geographical markets: the Americas, Europe and Asia. We currently maintain sales and support centers in major metropolitan areas in North America, Europe and Asia. We believe that a strong technical service presence is essential to the continued development of the embedded control market. Many of our field sales engineers (FSEs), field application engineers (FAEs), and sales management have technical degrees and have been previously employed in an engineering environment. We believe that the technical knowledge of our sales force is a key competitive advantage in the sale of our products. The primary mission of our FAE team is to provide technical assistance to strategic accounts and to conduct periodic training sessions for FSEs and distributor sales teams. FAEs also frequently conduct technical seminars in major cities around the world, and work closely with our distributors to provide technical assistance and end-user support.

Critical Accounting Policies and Estimates

General

Our discussion and analysis of Microchip's financial condition and results of operations is based upon our Condensed Consolidated Financial Statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. We review the accounting policies we use in reporting our financial results on a regular basis. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses and related disclosure of contingent liabilities. On an ongoing basis, we evaluate our estimates, including those related to revenue recognition, inventories, income taxes, property plant and equipment, impairment of property, plant and equipment and litigation. We base our estimates 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 value of assets and liabilities that are not readily apparent from other sources. Results may differ from these estimates due to actual outcomes being different from those on which we based our assumptions. We review these estimates and judgments on an ongoing basis. We believe the following critical accounting policies affect our more significant judgments and estimates used in the preparation of our

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consolidated financial statements. We also have other policies that we consider key accounting policies, such as our policy regarding revenue recognition to OEMs; however, we do not believe these policies require us to make estimates or judgments that are as difficult or subjective as our policies described below.

Revenue Recognition — Distributors

Our distributors worldwide have broad rights to return products and price protection, so we defer revenue recognition until the distributor sells the product to their customers. We reduce product pricing through price protection based on market conditions, competitive considerations and other factors. Price protection is granted to distributors on the inventory that they have on hand at the date the price protection is offered. When we reduce the price of our products, it allows the distributor to claim a credit against its outstanding accounts receivable balances based on the new price of the inventory it has on hand as of the date of the price reduction. There is no revenue impact from the price protection. We also grant certain credits to our distributors. The credits are granted to the distributors on specially identified pieces of the distributors' business to allow them to earn a competitive gross margin on the sale of our products to their end customers. The credits are on a per unit basis and are not given to the distributor until they provide documentation of the sale to their end customer. The effect of granting these credits establishes the net selling price from us to our distributors for the product and results in the net revenue recognized by us when the product is sold by the distributors to their end customers. Upon shipment, amounts billed to distributors are included as accounts receivable, inventory is relieved, and the sale and the gross margin are deferred and are reflected as a current liability until the product is sold by the distributor to their customers.

Inventories

Inventories are valued at the lower of cost or market using the first-in, first-out (FIFO) method. We write down our inventory for estimated obsolescence or unmarketable inventory in an amount equal to the difference between the cost of inventory and the estimated market value based upon assumptions about future demand and market conditions. If actual market conditions are less favorable than those we projected, additional inventory write-downs may be required. Inventory impairment charges establish a new cost basis for inventory and charges are not subsequently reversed to income even if circumstances later suggest that increased carrying amounts are recoverable. In estimating our reserves for obsolescence, we primarily evaluate estimates of demand over a 12-month period and provide reserves for inventory on hand in excess of the estimated 12-month demand.

Income Taxes

As part of the process of preparing our consolidated financial statements, we are required to estimate our income taxes in each of the jurisdictions in which we operate. This process involves estimating our actual current tax exposure together with assessing temporary differences resulting from differing treatment of items for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are included within our consolidated balance sheet. We must then assess the likelihood that our deferred tax assets will be recovered from future taxable income within the relevant jurisdiction and to the extent we believe that recovery is not likely, we must establish a valuation allowance. We have not provided for a valuation allowance because we believe that it is more likely than not that our deferred tax assets will be recovered from future taxable income. Should we determine that we would not be able to realize all or part of our net deferred tax asset in the future, an adjustment to the deferred tax asset would be charged to income in the period such determination was made. At September 30, 2005, our gross deferred tax asset was \$90.6 million.

Various taxing authorities in the United States and other countries in which we do business are increasing their scrutiny of various tax structures employed by businesses. Companies of our size and complexity are regularly audited by the taxing authorities in the jurisdictions in which they conduct significant operations. We are currently under audit by the United States Internal Revenue Service (IRS) for our fiscal years ended March 31, 1998, 1999, 2000 and 2001. As part of this ongoing audit, the IRS has proposed certain adjustments related to positions reflected on these returns. The IRS has issued formal assessments for these adjustments. We do not agree with these adjustments and intend to appeal these assessments. We recognize liabilities for anticipated tax audit issues in the United States and other tax jurisdictions based on our estimate of whether, and the extent to which, additional tax payments are probable. We believe that we maintain adequate tax reserves to offset any

potential tax liabilities that may arise upon final resolution of the pending audit through either settlement or the appeals process with the IRS. The IRS recently began an audit of our fiscal years ended March 31, 2002, 2003 and 2004. We believe that we maintain adequate tax reserves to offset any potential tax liabilities that may arise upon these and other audits in the United States and other countries in which we do business. If such amounts ultimately prove to be unnecessary, the resulting reversal of such reserves would result in tax benefits being recorded in the period the reserves are no longer deemed necessary. If such amounts ultimately prove to be less than an ultimate assessment, a future charge to expense would be recorded in the period in which the assessment is determined.

The foregoing statements regarding the recoverability of our deferred tax asset and the adequacy of our tax reserves are forward-looking statements. Actual results could differ materially because of the following factors, among others: results of any audit conducted by the various taxing authorities in the countries in which we do business; the level of our taxable income and whether our taxable income will be sufficient to realize the benefits available from our deferred tax assets; current and future tax laws and regulations; and taxation rates in geographic regions where we have significant operations.

Property, Plant & Equipment

Property, plant and equipment are stated at cost. Major renewals and improvements are capitalized, while maintenance and repairs are expensed when incurred. At September 30, 2005, the carrying value of our property and equipment totaled \$662.6 million, which represents 33.8% of our total assets. This carrying value reflects the application of our property and equipment accounting policies, which incorporate estimates, assumptions and judgments relative to the useful lives of our property and equipment. Depreciation is provided on a straight-line basis over the estimated useful lives of the related assets, which range from five to seven years on manufacturing equipment and approximately 30 years on buildings.

We began production activities at Fab 4 on October 31, 2003. We began to depreciate the Fab 4 equipment as the assets were placed in service for production purposes. As of September 30, 2005, all of the buildings and supporting facilities were being depreciated as well as the manufacturing equipment that had been placed in service. All manufacturing equipment that was not being used in production activities was maintained in projects in process and is not being depreciated until it is placed into service since management believes there is no change to its utility from the present time until it is placed into productive service. The lives to be used for depreciating this equipment at Fab 4 will be evaluated at such time as the assets are placed in service. We do not believe that the temporary idling of such assets has impaired the estimated life or carrying values of the underlying assets.

On March 31, 2005, we changed the classification of Fab 3 from an asset held-for-sale to an asset held-for-future-use. Fab 3 had been on the market for over two years, and we had not received any acceptable offers on the facility. Over that period of time, our business had increased significantly and over the next several years we will need to begin planning for future wafer fabrication capacity as a larger percentage of Fab 4's clean room capacity is utilized. We determined that the appropriate action to take was to stop actively marketing the Fab 3 facility and hold it for our future use. As a result of this change in classification, we had to assess the fair value of the Fab 3 asset to determine if any additional impairment charge was required upon the change in classification from "held-for-sale" to "held-for-future-use" under Statement of Financial Accounting Standards ("SFAS") No. 144. We performed a discounted cash flow analysis of the Fab 3 asset based on various financial projections in developing the fair value estimate given that it was the best available valuation technique for the asset. The discounted cash flow analysis confirmed the carrying value of the Fab 3 asset at March 31, 2005 was not in excess of its fair value. If indicators of impairment for the Fab 3 assets arise in the future, we will determine if the sum of the estimated undiscounted cash flows attributable to the assets in question are less than their carrying value. If less, we would recognize an impairment loss on the excess of the carrying amount of the assets over their respective fair values. We began to depreciate the Fab 3 assets in April 2005.

The estimates, assumptions and judgments we use in the application of our property and equipment policies reflect both historical experience and expectations regarding future industry conditions and operations.

The use of different estimates, assumptions and judgments regarding the useful lives of our property and equipment and expectations regarding future industry conditions and operations, would likely result in materially different carrying values of assets and results of operations.

We do not currently hold title to the land on which our Thailand facility resides. The land is subject to a complex restructuring situation relating to the seller of the land. We have provided reserves that we estimate will be adequate to obtain full title. Such reserves are set at the estimated fair value of the land. However, timing of the resolution is difficult to predict and the ultimate amount to be paid could change.

Impairment of Property, Plant and Equipment

We assess whether indicators of impairment of long-lived assets are present. If such indicators are present, we determine whether the sum of the estimated undiscounted cash flows attributable to the assets in question is less than their carrying value. If less, we recognize an impairment loss based on the excess of the carrying amount of the assets over their respective fair values. Fair value is determined by discounted future cash flows, appraisals or other methods. If the assets determined to be impaired are to be held and used, we recognize an impairment loss through a charge to our operating results to the extent the present value of anticipated net cash flows attributable to the asset are less than the asset's carrying value. We depreciate the carrying value over the remaining estimated useful life of the asset. We may incur impairment losses, or additional losses on already impaired assets, in future periods if factors influencing our estimates change.

Litigation

Our current estimated range of liability related to certain pending litigation is based on the probable loss of claims for which we can estimate the amount and range of loss. Recorded reserves were not significant at September 30, 2005.

Because of the uncertainties related to both the probability of loss and the amount and range of loss on the remaining pending litigation, we are unable to make a reasonable estimate of the liability that could result from an unfavorable outcome. As additional information becomes available, we will assess the potential liability related to our pending litigation and revise our estimates. Revisions in our estimates of the potential liability could materially impact our results of operation and financial position.

Results of Operations

The following table sets forth certain operational data as a percentage of net sales for the periods indicated:

	Three Months Ended September 30,		Six Months Ended September 30,	
	2005	2004	2005	2004
Net sales	100.0%	100.0%	100.0%	100.0%

Cost of sales	40.8%	42.7%	41.2%	42.8%
Gross profit	59.2%	57.3%	58.8%	57.2%
Research and development	10.4%	10.6%	10.5%	10.8%
Selling, general and administrative	13.9%	12.7%	14.1%	12.7%
Special charge	0.0%	0.0%	0.0%	4.9%
Operating income	34.9%	34.0%	34.2%	28.8%

Net Sales

We operate in one industry segment and engage primarily in the design, development, manufacture and marketing of semiconductor products. We sell our products to distributors and original equipment manufacturers, referred to as OEMs, in a broad range of market segments, perform on-going credit evaluations of our customers and generally require no collateral.

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Our net sales for the quarter ended September 30, 2005 were \$227.3 million, an increase of 4.0% from the previous quarter's sales of \$218.5 million, and an increase of 3.0% from net sales of \$220.7 million in the quarter ended September 30, 2004. Our net sales for the six months ended September 30, 2005 were \$445.8 million, an increase of 2.9%, from net sales of \$433.5 million in the six months ended September 30, 2004. The increases in net sales in these periods resulted primarily from increased demand across all of our product lines. Average selling prices for our products were down approximately 5% and 3% for the three and six-month periods ended September 30, 2005 over the corresponding periods of the previous fiscal year. The number of units of our products sold were up approximately 8% and 6% for the three and six-month periods ended September 30, 2005 over the corresponding period of the previous fiscal year. The average selling prices and the unit volumes of our sales are impacted by the mix of our products sold. Key factors in achieving the amount of net sales during the three and six-month periods ended September 30, 2005 include:

- continued market share gains
- increasing semiconductor content in our customers' products
- customers' increasing needs for the flexibility offered by our programmable solutions
- our new product offerings that have increased our served available market; and
- increasing demand for our products.

We recognize revenue from product sales upon shipment to OEMs. Under our shipping terms, legal title passes to the customer upon shipment from Microchip. We have no post shipment obligations. Distributors generally have broad rights to return products and price protection rights, so we defer revenue recognition until the distributors sell the product to their customers. Upon shipment, amounts billed to distributors are included in accounts receivable, inventory is relieved, the sale is deferred and the gross margin is reflected as a current liability until the product is sold by the distributors to their customers.

Sales by product line for the three and six months ended September 30, 2005 and September 30, 2004 were as follows (dollars in thousands):

	Three Months Ended September 30, (unaudited)				Six Months Ended September 30, (unaudited)			
	2005	%	2004	%	2005	%	2004	%
Microcontrollers	\$ 179,982	79.2%	\$ 176,316	79.9%	\$ 354,582	79.6%	\$ 343,007	79.1%
Memory products	32,603	14.3%	29,200	13.2%	62,584	14.0%	59,339	13.7%
Analog and interface products	14,713	6.5%	15,178	6.9%	28,659	6.4%	31,123	7.2%
Total sales	\$ 227,298	100.0%	\$ 220,694	100.0%	\$ 445,825	100%	\$ 433,469	100.0%

Microcontrollers

Our microcontroller product line represents the largest component of our total net sales. Microcontrollers and associated application development systems accounted for approximately 79.2% of our total net sales for the three-month period ended September 30, 2005 and approximately 79.6% of our total net sales for the six-month period ended September 30, 2005 compared to approximately 79.9% of our total net sales for the three-month period ended September 30, 2004 and approximately 79.1% of our total net sales for the six-month period ended September 30, 2004.

Net sales of our microcontroller products increased approximately 2.1% in the three-month period ended September 30, 2005 and 3.4% in the six-month period ended September 30, 2005 compared to the three and six-month periods ended September 30, 2004. These sales increases were primarily due to increased demand for our microcontroller products in end markets, driven principally by market share gains and those factors described on

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page 16 above. The end markets that we serve include the automotive, communications, computing, consumer and industrial control markets.

Historically, average selling prices in the semiconductor industry decrease over the life of any particular product. The overall average selling prices of our microcontroller products have remained relatively constant over time due to the proprietary nature of these products. We have experienced, and expect to continue to experience, moderate pricing pressure in certain microcontroller product lines, primarily due to competitive conditions. We have been able to in the past, and expect to be able to in the future, to moderate average selling price declines in our microcontroller product lines by introducing new products with more features and higher prices. We may be unable to maintain average selling prices for our microcontroller products as a result of increased pricing pressure in the future, which would adversely affect our operating results.

Memory Products

Sales of our memory products accounted for approximately 14.3% of our total net sales for the three-month period ended September 30, 2005 and 14.0% of our total net sales for the six-month period ended September 30, 2005 compared to approximately 13.2% of our total net sales for the three-month period ended September 30, 2004 and approximately 13.7% of our total net sales for the six-month period ended September 30, 2004.

Net sales of our memory products increased approximately 11.7% in the three-month period ended September 30, 2005 and approximately 5.5% in the six-month period ended September 30, 2005 compared to the three and six-month periods ended September 30, 2004. These sales increases were driven primarily by customer demand

conditions within the Serial EEPROM market, which products comprise substantially all of our memory product net sales.

Serial EEPROM product pricing has historically been cyclical in nature, with steep price declines followed by periods of relative price stability, driven by changes in industry capacity at different stages of the business cycle. We have experienced, and expect to continue to experience, varying degrees of competitive pricing pressures in our Serial EEPROM products. We may be unable to maintain the average selling prices of our Serial EEPROM products as a result of increased pricing pressure in the future, which could adversely affect our operating results.

Analog and Interface Products

Sales of our analog and interface products accounted for approximately 6.5% of our total net sales for the three-month period ended September 30, 2005 and 6.4% of our total net sales for the six-month period ended September 30, 2005 compared to approximately 6.9% of our total net sales for the three-month period ended September 30, 2004 and approximately 7.2% of our total net sales for the six-month period ended September 30, 2005.

Net sales of our analog and interface products decreased approximately 3.1% in the three-month period ended September 30, 2005 and approximately 7.9% in the six-month period ended September 30, 2005 compared to the three and six-month periods ended September 30, 2004. These sales decreases in our analog and interface products were driven primarily by supply and demand conditions within the analog and interface market.

Analog and interface products can be proprietary or non-proprietary in nature. Currently, we consider more than half of our analog and interface product mix to be proprietary in nature, where prices are relatively stable, similar to the pricing stability experienced in our microcontroller products. The non-proprietary portion of our analog and interface business will experience price fluctuations, driven primarily by the current supply and demand for those products. We may be unable to maintain the average selling prices of our analog and interface products as a result of increased pricing pressure in the future, which would adversely affect our operating results. We anticipate the proprietary portion of our analog and interface products will increase over time.

Turns Orders

Our net sales in any given quarter depend upon a combination of shipments from backlog and orders received in that quarter for shipment in that quarter, which we refer to as turns orders. Historically, we have proven our ability to respond quickly to customer orders as part of our competitive strategy, resulting in customers placing orders with short delivery schedules. Shorter lead times generally mean that turns orders as a percentage of our business are relatively high in any particular quarter and reduces our backlog visibility on future product shipments. Turns orders correlate to overall semiconductor industry conditions and product lead times. Turns orders are difficult to predict, and we may not experience the combination of turns orders and shipments from backlog in a quarter that would be sufficient to achieve anticipated net sales. If we do not achieve a sufficient level of turns orders in a particular quarter, our net sales and operating results may suffer.

The foregoing statements regarding competitive pricing pressure in our microcontroller, Serial EEPROM and analog and interface product lines, our ability to moderate future average selling price declines in our microcontroller product lines and the proprietary portion of our analog and interface product lines increasing over time are forward-looking statements. Actual results could differ materially because of the following factors, among others: the level of orders that are received and can be shipped in a quarter; changes in demand for our products and the products of our customers; the level and timing at which previous design wins become actual orders and sales; inventory mix and timing of customer orders; customers' inventory levels, order patterns and seasonality; level of sell-through of our products through distribution in any particular fiscal period; our ability to ramp products into volume production; competition and competitive pressures on pricing and product availability; disruptions in commercial activities, or international transport or delivery occasioned by terrorist activity, armed conflict, war, natural disasters or an unexpected increase in the price of, or decrease in the supply of, oil resulting in reduced end-user purchases relative to expectations; impact of events outside the United States, such as the business impact of fluctuating currency rates or unrest or political instability; the cyclical nature of both the semiconductor industry and the markets addressed by our products; market acceptance of our new products and those of our customers; the financial condition of our customers; fluctuations in production yields, production efficiencies and overall capacity utilization; changes in product mix; absorption of fixed costs, labor and other fixed manufacturing costs; and general industry, economic and political conditions.

Distribution

Distributors accounted for approximately 64% of our net sales in the three-month periods ended September 30, 2005 and September 30, 2004. Distributors accounted for approximately 65% of our net sales in the six-month periods ended September 30, 2005 and September 30, 2004.

Our two largest distributors together accounted for approximately 24% of our net sales in the three and six-month periods ended September 30, 2005. Our two largest distributors together accounted for approximately 24% of our net sales in the three-month period ended September 30, 2004 and approximately 25% of our net sales in the six-month period ended September 30, 2004.

Generally, we do not have long-term agreements with our distributors and we, or our distributors, may terminate our relationships with each other with little or no advanced notice. The loss of, or the disruption in the operations of, one or more of our distributors could reduce our future net sales in a given quarter and could result in an increase in inventory returns.

At September 30, 2005, distributors were maintaining an average of approximately 2.0 months of inventory of our products. Over the past three fiscal years, the months of inventory maintained by our distributors have fluctuated between approximately 2.0 and 2.8 months. Thus, inventory levels at our distributors are at the low end of the range we have experienced over the last three years. As we recognize revenue based on sell through for all of our distributors, we do not believe that inventory holding patterns at our distributors will materially impact our net sales.

The foregoing statement regarding our belief that inventory holding patterns at our distributors will not materially impact our net sales is a forward-looking statement. Actual results could differ materially because of the following factors, among others: the activity level in the overall economy and the uncertainty of current

economic and political conditions; changes in demand for our products and the products of our customers; the level and timing at which previous design wins become actual orders and sales; inventory mix and timing of customer orders; customers' inventory levels, order patterns and seasonality; the impact on our business and customer order patterns due to major public health concerns, such as the SARS virus; level of sell-through of our products through distribution in any particular fiscal period; disruptions in commercial activities, or international transport or delivery occasioned by terrorist activity, armed conflict, war, natural disasters or an unexpected increase in the price of, or decrease in the supply of, oil resulting in reduced end-user purchases relative to expectations; impact of events outside the United States, such as the business impact of

fluctuating currency rates or unrest or political instability; the cyclical nature of both the semiconductor industry and the markets addressed by our products; market acceptance of our new products and those of our customers; and the financial condition of our customers.

Sales by Geography.

Sales by geography for the three and six-month periods ended September 30, 2005 and 2004 were as follows (dollars in thousands):

	Three Months Ended September 30, (unaudited)				Six Months Ended September 30, (unaudited)			
	2005	%	2004	%	2005	%	2004	%
Americas	\$ 65,072	28.6%	\$ 63,968	29.0%	\$ 127,942	28.7%	\$ 126,092	29.1%
Europe	61,229	27.0%	59,532	27.0%	124,188	27.9%	119,618	27.6%
Asia	100,997	44.4%	97,194	44.0%	193,695	43.4%	187,759	43.3%
Total sales	\$ 227,298	100.0%	\$ 220,694	100.0%	\$ 445,825	100.0%	\$ 433,469	100.0%

Our sales to foreign customers have been predominately in Asia and Europe, which we attribute to the manufacturing strength in those areas for automotive, communications, computing, consumer and industrial control products. Americas sales include sales to customers in the United States, Canada, Central America and South America.

Sales to foreign customers accounted for approximately 73% of our net sales in three and six-month periods ended September 30, 2005. Sales to foreign customers accounted for approximately 74% of our net sales in the three-month period ended September 30, 2004 and approximately 73% of our net sales in the six-month period ended September 30, 2004. Substantially all of our foreign sales are U.S. dollar denominated.

Gross Profit

Our gross profit was \$134.6 million in the three months ended September 30, 2005, and \$126.4 million in the three months ended September 30, 2004. Our gross profit was \$262.1 million in the six months ended September 30, 2005, and \$247.8 million in the six months ended September 30, 2004. Gross profit as a percent of sales was 59.2% in the three months ended September 30, 2005, and 57.3% in the three months ended September 30, 2004. Gross profit as a percent of sales was 58.8% in the six months ended September 30, 2005, and 57.2% in the six months ended September 30, 2004.

The most significant factors affecting our gross profit percentage in the periods covered by this report were:

- improvements in capacity utilization and absorption of fixed costs which positively affected gross margin by \$5.0 million and \$8.3 million in the three and six-month periods ending September 30, 2005 over the corresponding periods of the previous fiscal year; and

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- increases in period cost of sales related to Fab 3, our non-operational facility, which amounted to \$1.4 million and \$2.8 million in the three and six-month periods ending September 30, 2005 and \$0.8 million and \$1.6 million in the three and six-month periods ending September 30, 2004.

Other factors that impacted gross profit percentage in the periods covered by this report include:

- continued cost reductions in wafer fabrication and assembly and test manufacturing such as new manufacturing technologies and more efficient manufacturing techniques;
- varying factors impacting the average selling prices of our products;
- fluctuations in the product mix of microcontrollers, proprietary and non-proprietary analog products and Serial EEPROM products; and
- inventory write-offs and the sale of inventory that was previously written-off.

During the three-month period ended September 30, 2005, we operated at approximately 98% of our Fab 2 capacity, which favorably impacted gross margins compared to the same period of the previous fiscal year. Our utilization of Fab 4's total capacity is at relatively low levels although we are utilizing all of the installed equipment base. We expect to maintain the capacity utilization at approximately the same levels at Fab 2 and Fab 4 during the third quarter of fiscal 2006.

The process technologies utilized impact our gross margins. Fab 2 currently utilizes various manufacturing process technologies, but predominantly utilizes our 0.5 to 1.0 micron processes. At September 30, 2005, Fab 4 predominantly utilized our 0.5 micron process technology. We continue to transition products to more advanced process technologies to reduce future manufacturing costs. All of our production has been on 8-inch wafers for the periods covered by this report.

Our overall inventory levels were \$110.2 million at September 30, 2005 compared to \$103.7 million at March 31, 2005. We had 108 days of inventory on our balance sheet at September 30, 2005 compared to 107 days at March 31, 2005 and 87 days at September 30, 2004.

We anticipate that our gross margins will fluctuate over time, driven primarily by the overall product mix of microcontroller, analog and interface and memory products and the percentage of net sales of each of these products in a particular quarter, as well as manufacturing yields, fixed cost absorption, capacity utilization levels, particularly those at Fab 4, and competitive and economic conditions.

The foregoing statements relating to our expectation to maintain the current level of capacity utilization at Fab 2 and Fab 4 during the third quarter of fiscal 2006, our transition to more advanced process technologies to reduce future manufacturing costs and the fluctuation of gross margins over time are forward-looking statements. Actual results could differ materially because of the following factors, among others: changes in demand for our products and the products of our customers; fluctuations in production yields, production efficiencies and overall capacity utilization; absorption of fixed costs, labor and other direct manufacturing costs; competition and competitive pressure on pricing; disruptions in commercial activities, or international transport or delivery occasioned by terrorist activity, armed conflict, war, natural disasters or an unexpected increase in the price of, or decrease in the supply of, oil resulting in reduced end-user purchases relative to expectations; impact of events outside the United States, such as the business impact of fluctuating currency rates or unrest or political instability; our ability to increase manufacturing capacity as needed; cost and availability of raw materials; changes in product mix; and other general industry, economic and political conditions.

At September 30, 2005, approximately 67% of our assembly requirements were being performed in our Thailand facility, compared to approximately 69% as of September 30, 2004. Third-party contractors located in Asia perform the balance of our assembly operations. Substantially all of our test requirements were being performed in our Thailand facility as of September 30, 2005 and September 30, 2004. We believe that the assembly and test operations performed at our Thailand facility provide us with significant cost savings when compared to third-party contractor assembly and test costs, as well as increased control over these portions of the manufacturing process.

We rely on outside wafer foundries for a small portion of our wafer fabrication requirements.

Our use of third parties involves some reduction in our level of control over the portions of our business that we subcontract. While we review the quality, delivery and cost performance of our third-party contractors, our future operating results could suffer if any third-party contractor is unable to maintain manufacturing yields, assembly and test yields and costs at approximately their current levels.

Research and Development (R&D)

R&D expenses for the three months ended September 30, 2005 were \$23.6 million, or 10.4% of sales, compared to \$23.3 million, or 10.6% of sales, for the three months ended September 30, 2004. R&D expenses for the six months ended September 30, 2005 were \$47.0 million, or 10.5% of sales, compared to \$46.6 million, or 10.8% of sales for the six months ended September 30, 2004. We are committed to investing in new and enhanced products, including development systems software, and in our design and manufacturing process technologies. We believe these investments are significant factors in maintaining our competitive position. We expense all R&D costs as incurred. R&D expenses include labor, depreciation, masks, prototype wafers, and expenses for the development of process technologies, new packages, and software to support new products and design environments.

Selling, General and Administrative

Selling, general and administrative expenses for the three months ended September 30, 2005 were \$31.6 million, or 13.9% of sales, compared to \$28.0 million, or 12.7% of sales, for the three months ended September 30, 2004. Selling, general and administrative expenses for the six months ended September 30, 2005 were \$62.7 million, or 14.1% of sales, compared to \$55.2 million, or 12.7% of sales, for the six months ended September 30, 2004. Selling, general and administrative expenses include salary expenses related to field sales, marketing and administrative personnel, advertising and promotional expenditures and legal expenses. Selling, general and administrative expenses also include costs related to our direct sales force and field applications engineers who work in sales offices worldwide to stimulate demand by assisting customers in the selection and use of our products.

Selling, general and administrative expenses increased \$3.6 million, or 12.9%, for the three months ended September 30, 2005 over the same period last year. Selling, general and administrative expenses increased \$7.5 million, or 13.5%, for the six months ended September 30, 2005 over the same period last year. The primary reason for the increase in selling, general and administrative expenses in these periods was higher labor costs as a result of expanding our internal resources involved in the technical aspect of selling our products.

Selling, general and administrative expenses fluctuate over time, primarily due to revenue and operating expense levels.

Special Charges

In fiscal 2005 we reached an agreement with U.S. Philips Corporation and Philips Electronics North America Corp. (together "Philips") regarding patent license litigation between Philips and ourselves which had been ongoing since October 2001. The agreement included dismissal of the then pending litigation and the cross-license of certain patents between Philips and Microchip. We recorded a special charge of \$21.1 million in the quarter ended June 30, 2004 associated with this matter. As part of the settlement, we licensed certain of our patents related to 8-pin microcontrollers to Philips, and Philips licensed its patents related to I²C serial communications to us, each on fully-paid up, non-royalty bearing worldwide licenses. The definitive agreement related to this matter was finalized and executed and the cash payment was made by us to Philips during our fiscal quarter ending September 30, 2004.

Other Income (Expense)

Interest income in the three and six-month periods ended September 30, 2005 increased from interest income in the three and six-month periods ended September 30, 2004 as our average invested cash balances and

the average interest rates on those invested cash balances were at higher levels in the periods ended September 30, 2005 compared to the same periods in the last fiscal year.

Provision for Income Taxes

Provisions for income taxes reflect tax on foreign earnings and federal and state tax on U.S. earnings. We had an effective tax rate of 24.0% for the six months ended September 30, 2005. We had an effective tax rate of 21.7% for the six months ended September 30, 2004, including the tax effects from the \$21.1 million special charge related to the Philips settlement which was tax effected at our applicable U.S. federal and state tax rate of 38.5%. See Note 9 to our Condensed Consolidated Financial Statements for additional information on our effective tax rates.

At September 30, 2005, our gross deferred tax asset was \$90.6 million. Our gross deferred tax asset decreased by \$14.5 million in the six months ended September 30, 2005 compared to the level at March 31, 2005, due primarily to increases in income which allowed us to utilize tax credits and changes in various temporary differences between our book and tax reporting. At September 30, 2005, our deferred tax liability was \$17.3 million. Our gross deferred tax liability decreased by \$7.3 million in the six months ended September 30, 2005 compared to the level at March 31, 2005, due primarily to changes in temporary differences in depreciation between our book and tax reporting.

Our Thailand manufacturing operations currently benefit from numerous tax holidays that have been granted to us by the Thailand government based on our investments in property, plant and equipment in Thailand. Our tax holiday periods in Thailand expire at various times beginning in September 2006. We do not expect the future expiration of any of our tax holiday periods in Thailand to have a material impact on our effective tax rate. Any expiration of tax holidays are expected to be offset by other tax holidays.

The American Jobs Creation Act of 2004 (the “Jobs Act”), enacted on October 22, 2004, provides for a temporary deduction of 85% of dividends received on certain foreign earnings repatriated during a one-year period. The deduction would result in an approximate 5.25% federal tax rate on the repatriated earnings. To qualify for the deduction, the earnings must be reinvested in the United States pursuant to a domestic reinvestment plan established by a company’s chief executive officer and approved by the company’s board of directors. Certain other criteria in the Jobs Act must be satisfied as well. The maximum amount of our foreign earnings that qualify for the temporary deduction is \$500 million and would need to be distributed prior to the end of fiscal 2006.

We are in the process of evaluating whether we will repatriate foreign earnings under the repatriation provisions of the Jobs Act, and if so, the amount that will be repatriated. The range of reasonably possible amounts that we are considering for repatriation, which would be eligible for the temporary deduction, is zero to \$500 million. We are in the process of analyzing and evaluating the recently issued regulatory guidance and statutory technical corrections associated with the Jobs Act to determine the amount, if any, we will repatriate. We expect to determine the amounts and sources of foreign earnings to be repatriated, if any, during fiscal 2006.

We are not yet in a position to determine the impact of a qualifying repatriation, should we choose to make one, on our income tax expense for fiscal 2006. If we were to plan to repatriate the maximum amount eligible for the temporary deduction, which is \$500 million, from foreign earnings which were previously indefinitely reinvested, we estimate we would incur additional tax expense in fiscal 2006 of approximately \$34.3 million.

The foregoing statements regarding the adequacy of our tax reserves to offset any potential tax liabilities that may arise upon audit, the impact of expiring tax holidays being offset by other tax holidays, the range of possible repatriation amounts and the estimated amount of additional tax expense are forward-looking statements. Actual results could differ materially because of the following factors, among others: current and future tax laws and regulations; taxation rates in geographic regions where we have significant operations; results of any current or future audit conducted by the U.S. Internal Revenue Service or other taxing authorities in the countries in which we do business; the level of our taxable income; whether our taxable income will be sufficient to utilize our deferred tax asset; and future guidance or regulations published with respect to the Jobs Act.

Liquidity and Capital Resources

We had \$902.5 million in cash, cash equivalents and short-term investments at September 30, 2005, an increase of \$167.9 million from the March 31, 2005 balance. The increase in cash, cash equivalents and short-term investments over this time period is primarily attributable to cash generated from operating activities.

We maintain an unsecured short-term line of credit with various financial institutions in Asia totaling \$5.0 million (U.S. dollar equivalent). There were no borrowings under the foreign line of credit as of September 30, 2005, but an allocation of approximately \$0.4 million of the available line was made, relating to import guarantees associated with our business in Thailand. There are no covenants related to the foreign line of credit.

Net cash provided from operating activities was \$203.1 for the six-month period ended September 30, 2005 compared to \$185.0 million for the six-month period ended September 30, 2004. The increase in cash flow from operations was primarily from increases in profitability and increases in accounts payable and accrued liability balances, which were offset by changes in deferred income taxes, increases in inventory and changes in deferred income on shipments to distributors.

During the six months ended September 30, 2005, net cash used in investing activities decreased \$44.3 million, to \$152.4 million, from \$196.7 million for the six months ended September 30, 2004. The decrease was due primarily to changes in our net purchases, sales and maturities of short-term investments and decreases in capital expenditures in the six months ended September 30, 2005.

We enter into hedging transactions from time to time in an attempt to minimize our exposure to currency rate fluctuations. The amount of the hedges outstanding at September 30, 2005 were immaterial. Although none of the countries in which we conduct significant foreign operations have had a highly inflationary economy in the last five years, there is no assurance that inflation rates or fluctuations in foreign currency rates in countries where we conduct operations will not adversely affect our operating results in the future.

Our level of capital expenditures varies from time to time as a result of actual and anticipated business conditions. Capital expenditures in the six months ended September 30, 2005 were \$25.2 million compared to \$34.1 million for the six months ended September 30, 2004. Capital expenditures are primarily for the expansion of production capacity and the addition of research and development equipment. We currently anticipate spending approximately \$70 million during the next 12 months to invest in equipment and facilities to maintain, and selectively increase, capacity to meet our currently anticipated needs.

We expect to finance capital expenditures through our existing cash balances and cash flows from operations. We believe that the capital expenditures anticipated to be incurred over the next 12 months will provide sufficient manufacturing capacity to meet our currently anticipated needs.

Net cash used in financing activities was \$9.4 million for the six months ended September 30, 2005 compared to \$18.4 million for the six months ended September 30, 2004. Proceeds from the exercise of stock options and employee purchases under our employee stock purchase plan were \$36.6 million for the six months ended September 30, 2005 and \$22.2 million for the six months ended September 30, 2004. Cash expended for the repurchase of our common stock was \$65.1 million in the six months ended June 30, 2004. We did not repurchase any of our common stock in the six months ended September 30, 2005. We paid cash dividends to our shareholders in the six months ended September 30, 2005 of \$46.0 million and \$17.7 million in the six months ended September 30, 2004. Proceeds from short-term borrowings were \$42.3 million in the six months ended September 30, 2004.

On April 22, 2004, our Board of Directors authorized the repurchase of 2.5 million shares of our common stock in the open market or in privately negotiated transactions. As of September 30, 2005, we had repurchased 884,900 common shares under this authorization for a total of \$23.3 million. As of September 30, 2005, all of the purchased shares under the authorization were used to fund stock option exercises and purchases under our

employee stock purchase plan. The timing and amount of any future repurchases will depend upon market conditions and corporate considerations.

On October 28, 2002, we announced that our Board of Directors had approved and instituted a quarterly cash dividend on our common stock. The initial quarterly dividend of \$0.02 per share was paid on December 6, 2003 in the aggregate amount of \$4.0 million. We have continued to pay quarterly dividends and have increased the amount of such dividends on a regular basis. A quarterly dividend of \$0.125 per share was paid on September 1, 2005 in the aggregate amount of \$26.2 million. A quarterly dividend of \$0.16 per share was declared on October 20, 2005 and will be paid on November 18, 2005 to shareholders of record as of November 3, 2005. We expect the December 2005 cash dividend to be approximately \$33.6 million. During fiscal 2005, we paid dividends in the amount of \$0.208 per share for a total dividend payment of \$43.0 million. Since the inception of our dividend program, we have paid cumulative dividends of \$120.4 million.

We believe that our existing sources of liquidity combined with cash generated from operations will be sufficient to meet our currently anticipated cash requirements for at least the next 12 months. However, the semiconductor industry is capital intensive. In order to remain competitive, we must constantly evaluate the need to make significant investments in capital equipment for both production and research and development. We may seek additional equity or debt financing from time to time to maintain or expand our wafer fabrication and product assembly and test facilities, or for other purposes. The timing and amount of any such financing requirements will depend on a number of factors, including demand for our products, changes in industry conditions, product mix, and competitive factors. There can be no assurance that such financing will be available on acceptable terms, and any additional equity financing would result in incremental ownership dilution to our existing stockholders.

The foregoing statements regarding our anticipated level of capital expenditures over the next 12 months, the nature of such expenditures, the financing and sufficiency of our capital expenditures, our belief that existing sources of liquidity will be sufficient to meet our requirements and our anticipated payment of cash dividends are forward-looking statements. Actual results could differ materially because of the following factors, among others: changes in demand for our products and those of our customers; changes in utilization of current manufacturing capacity; unanticipated costs in continuing to ramp production at Fab 4; market acceptance of our products and of our customers' products; the cyclical nature of the semiconductor industry and the markets addressed by our products; the availability and cost of raw materials, equipment and other supplies; actual levels of capital expenditures; the costs and outcome of any tax audit or any litigation involving intellectual property, customers or other issues; the financial condition of our customers and vendors; uninsured losses; and the economic, political and other conditions in the worldwide markets served by us.

Contractual Obligations

There have not been any material changes in our contractual obligations from what we disclosed in our Annual Report on Form 10-K for the year ended March 31, 2005.

Off-Balance Sheet Arrangements

As of September 30, 2005, we are not involved in any off-balance sheet arrangements, as defined in Item 3(a)(4)(ii) of SEC Regulation S-K.

Recently Issued Accounting Pronouncements

During December 2004, the FASB issued SFAS No. 123R which requires companies to measure and recognize compensation expense for all share-based payments at fair value. Share-based payments include stock option grants. We grant options to purchase common stock to our employees and directors under our stock option plan at prices equal to the market value of the stock on the dates the options were granted. SFAS No. 123R is effective for us beginning April 1, 2006. Early adoption of the provisions of SFAS No. 123R is encouraged, but not required. We have not yet adopted this pronouncement and are currently evaluating the expected impact that the adoption of SFAS No. 123R will have on our consolidated financial position and results of operations. We expect the adoption of SFAS No. 123R will have an unfavorable impact on our consolidated results of operations

and net income per common share. SFAS No. 123R also requires the benefits of tax deductions in excess of recognized compensation cost to be reported as a financing cash flow, rather than as an operating cash flow as required under current guidelines. This requirement will reduce our net operating cash flows and increase our net financing cash flows in periods after adoption. We cannot estimate what those amounts will be in the future because they depend on, among other things, when employees exercise stock options.

FASB Staff Position ("FSP") No. 109-2, "Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provision within the American Jobs Creation Act of 2004" ("FSP 109-2"), provides guidance under FASB Statement No. 109, "Accounting for Income Taxes," ("SFAS 109") with respect to recording the potential impact of the repatriation provisions of the American Jobs Creation Act of 2004 (the "Jobs Creation Act") on enterprises' income tax expense and deferred tax liability. The Jobs Creation Act was enacted on October 22, 2004. FSP 109-2 states that an enterprise is allowed time beyond the financial reporting period of enactment to evaluate the effect of the Jobs Act on its plan for reinvestment or repatriation of foreign earnings for purposes of applying SFAS 109. As of September 30, 2005, we were in the process of evaluating whether we will repatriate any foreign earnings under the Act and, if so, the amount that we will repatriate. However, we do not expect to be able to complete this evaluation until later in fiscal 2006. Accordingly, as provided for in FSP 109-2, we have not adjusted our tax expense or deferred tax liability to reflect the repatriation provisions of the Jobs Creation Act. The Jobs Creation Act also provides a deduction for income from qualified domestic production activities, to be phased in from 2005 through 2010, which is intended to replace the existing extra-territorial income exclusion for foreign sales. In FSP 109-1, the FASB decided the deduction for qualified domestic production activities should be accounted for as a special deduction under SFAS 109, rather than as a rate reduction. Accordingly, any benefit from the deduction will be reported in the period in which the deduction is claimed on the tax return and no adjustment to deferred taxes at September 30, 2005 is required.

In March 2004, the FASB approved the consensus reached on the Emerging Issues Task Force (EITF) Issue No. 03-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments" ("EITF 03-1"). The Issue's objective is to provide guidance for identifying other-than-temporarily impaired investments. EITF 03-1 also provides new disclosure requirements for investments that are deemed to be temporarily impaired. In September 2004, the FASB issued a FSP EITF 03-1-1 that delays the effective date of the measurement and recognition guidance in EITF 03-1 until further notice. The disclosure requirements of EITF 03-1 were effective with our annual report for fiscal 2005. Once the FASB reaches a final decision on the measurement and recognition provisions, we will evaluate the impact of the adoption of the accounting provisions of EITF 03-1.

In December 2004, the FASB also issued SFAS No. 151, "Inventory Costs, an amendment of ARB No. 43, Chapter 4," ("SFAS 151") which will become effective for us beginning January 1, 2006. This standard clarifies that abnormal amounts of idle facility expense, freight, handling costs and wasted material should be expensed as incurred and not included in overhead. In addition, this standard requires that the allocation of fixed production overhead costs to inventory be based on the normal capacity of the production facilities. We are currently evaluating the potential impact of this standard on our financial position and results of operations, but do not believe the impact of the change will be material.

Additional Factors That May Affect Results of Operations

When evaluating Microchip and its business, you should give careful consideration to the factors listed below, in addition to the information provided elsewhere in this Form 10-Q and in other documents that we file with the Securities and Exchange Commission.

Our quarterly operating results may fluctuate due to factors that could reduce our net sales and profitability.

Our quarterly operating results are affected by a wide variety of factors that could reduce our net sales and profitability, many of which are beyond our control. Some of the factors that may affect our quarterly operating results include:

- changes in demand or market acceptance of our products and products of our customers
- the mix of inventory we hold and our ability to satisfy orders from our inventory
- levels of inventories at our customers
- changes in utilization of our manufacturing capacity and fluctuations in manufacturing yields
- our ability to secure sufficient assembly and testing capacity
- competitive developments including pricing pressures
- the level of orders that are received and can be shipped in a quarter
- the level of sell-through of our products through distribution
- changes or fluctuations in customer order patterns and seasonality
- constrained availability from other electronic suppliers impacting our customers' ability to ship their products, which in turn may adversely impact our sales to those customers
- costs and outcomes of any pending or future tax audits or any litigation involving intellectual property, customers or other issues
- disruptions in our business, our vendors' businesses or our customers' businesses due to terrorist activity, armed conflict, war, natural disasters, worldwide oil prices and supply, public health concerns or disruptions in the transportation system
- property damage or other losses which are not covered by insurance, and
- general economic, industry or political conditions in the United States or internationally.

We believe that period-to-period comparisons of our operating results are not necessarily meaningful and that you should not rely upon any such comparisons as indications of future performance. In future periods our operating results may fall below our public guidance or the expectations of public market analysts and investors, which would likely have a negative effect on the price of our common stock.

Our operating results will suffer if we ineffectively utilize our manufacturing capacity or fail to maintain manufacturing yields.

The manufacture and assembly of integrated circuits, particularly non-volatile, erasable CMOS memory and logic devices such as those that we produce, are complex processes. These processes are sensitive to a wide variety of factors, including the level of contaminants in the manufacturing environment, impurities in the materials used and the performance of our wafer fabrication personnel and equipment. As is typical in the semiconductor industry, we have from time to time experienced lower than anticipated manufacturing yields. Our operating results will suffer if we are unable to maintain yields at approximately the current levels.

Our operating results are also adversely affected when we operate at less than optimal capacity. Lower capacity utilization results in certain costs being charged directly to expense and lower gross margins.

We are dependent on orders that are received and shipped in the same quarter and therefore limited in our visibility of future product shipments.

Our net sales in any given quarter depend upon a combination of shipments from backlog and orders received in that quarter for shipment in that quarter, which we refer to as turns orders. Historically, we have proven our ability to respond quickly to customer orders as part of our competitive strategy, resulting in customers placing orders with relatively short delivery schedules. Shorter lead times generally mean that turns orders as a percentage of our business are relatively high in any particular quarter and reduces our backlog visibility on future product shipments. Turns orders correlate to overall semiconductor industry conditions and product lead times. Because turns orders are difficult to predict, varying levels of turns orders make our net sales more difficult to forecast. If we do not achieve a sufficient level of turns orders in a particular quarter relative to our revenue targets, our revenue and operating results may suffer.

Intense competition in the markets we serve may lead to pricing pressures, reduced sales of our products or reduced market share.

The semiconductor industry is intensely competitive and has been characterized by price erosion and rapid technological change. We compete with major domestic and international semiconductor companies, many

of which have greater market recognition and substantially greater financial, technical, marketing, distribution and other resources than we do with which to pursue engineering, manufacturing, marketing and distribution of their products. Emerging companies are also increasing their participation in the market for embedded control applications. We may be unable to compete successfully in the future, which could harm our business.

Our ability to compete successfully depends on a number of factors both within and outside our control, including:

- the quality, performance, reliability, features, ease of use, pricing and diversity of our products
- our success in designing and manufacturing new products including those implementing new technologies
- the rate at which customers incorporate our products into their own applications
- product introductions by our competitors
- the number, nature and success of our competitors in a given market
- our ability to obtain adequate supplies of raw materials and other supplies at acceptable prices
- our ability to protect our products and processes by effective utilization of intellectual property rights
- the quality of our customer service and our ability to address the needs of our customers, and
- general market and economic conditions.

Historically, average selling prices in the semiconductor industry decrease over the life of any particular product. The overall average selling prices of our microcontroller and proprietary analog and interface products have remained relatively constant, while average selling prices of our Serial EEPROM and non-proprietary analog and interface products have declined over time.

We have experienced, and expect to continue to experience, modest pricing declines in certain of our more mature proprietary product lines, due primarily to competitive conditions. We have been able to moderate average selling price declines in many of our proprietary product lines by continuing to introduce new products with more features and higher prices. We have experienced in the past and expect to continue to experience in the future varying degrees of competitive pricing pressures in our Serial EEPROM products.

We may be unable to maintain average selling prices for our products as a result of increased pricing pressure in the future, which could adversely impact our operating results.

Our business is highly dependent on selling through distributors.

Sales through distributors accounted for 65% of our net sales in fiscal 2005 and the first six months of fiscal 2006. Our two largest distributors together accounted for approximately 25% of our net sales in fiscal 2005 and 24% of our net sales in the first six months of fiscal 2006. We do not have long-term agreements with our distributors and our distributors may terminate their relationships with us with little or no advanced notice.

The loss of, or a disruption in the operations of, one or more of our distributors could reduce our net sales in a given quarter and could result in an increase in inventory returns.

Our success depends on our ability to introduce new products on a timely basis.

Our future operating results will depend on our ability to develop and introduce new products on a timely basis that can compete effectively on the basis of price and performance and which address customer requirements. The success of our new product introductions depends on various factors, including:

- proper new product selection
- timely completion and introduction of new product designs
- development of support tools and collateral literature that make complex new products easy for engineers to understand and use, and
- market acceptance of our customers' end products.

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Because our products are complex, we have experienced delays from time to time in completing development of new products. In addition, our new products may not receive or maintain substantial market acceptance. We may be unable to design, develop and introduce competitive products on a timely basis, which could adversely impact our future operating results.

Our success also depends upon our ability to develop and implement new design and process technologies. Semiconductor design and process technologies are subject to rapid technological change and require significant R&D expenditures. We and other companies in the industry have, from time to time, experienced difficulties in effecting transitions to advanced process technologies and, consequently, have suffered reduced manufacturing yields or delays in product deliveries. Our future operating results could be adversely affected if any transition to future process technologies is substantially delayed or inefficiently implemented.

We must attract and retain qualified personnel to be successful, and competition for qualified personnel is intense in our market.

Our success depends upon the efforts and abilities of our senior management, engineering and other personnel. The competition for qualified engineering and management personnel is intense. We may be unsuccessful in retaining our existing key personnel or in attracting and retaining additional key personnel that we require. The loss of the services of one or more of our key personnel or the inability to add key personnel could harm our business. We have no employment agreements with any member of our senior management team.

We are dependent on several third-party contractors to perform key manufacturing functions for us.

We use several third-party contractors located in Asia for a portion of the assembly and testing of our products. We also rely on outside wafer foundries for a portion of our wafer fabrication. Although we own the majority of our manufacturing resources, the disruption or termination of any of our third-party contractors could harm our business and operating results.

Our use of third parties involves some reduction in our level of control over the portions of our business that we subcontract. Our future operating results could suffer if any third-party contractor were to experience financial, operations or production difficulties or situations when demand exceeds capacity, or if they were unable to maintain manufacturing yields, assembly and test yields and costs at approximately their current levels, or if due to their locations in foreign countries they were to experience political upheaval or infrastructure disruption. In such case, we may not be able to qualify additional manufacturing sources for our products in a timely manner or at all, and such arrangements, if any, may not be on favorable terms to us. In such event, our business and operating results could be adversely affected.

We may lose sales if our suppliers of raw materials and equipment fail to meet our needs.

Our semiconductor manufacturing operations require raw materials and equipment that must meet exacting standards. We generally have more than one source for these supplies, but there are only a limited number of suppliers capable of delivering various raw materials and equipment that meet our standards. The raw materials and equipment necessary for our business could become more difficult to obtain as worldwide use of semiconductors in product applications increases. We have experienced supply shortages from time to time in the past, and on occasion our suppliers have told us they need more time than expected to fill our orders or that they will no longer support certain equipment with updates or spare and replacements parts. An interruption of any raw materials or equipment sources, or the lack of supplier support for a particular piece of equipment, could harm our business.

Our operating results may be impacted by the wide fluctuations of supply and demand in the semiconductor industry.

The semiconductor industry is characterized by wide fluctuations of supply and demand. The industry has experienced significant economic downturns, characterized by diminished product demand and production over-capacity. We have sought to reduce our exposure to this industry cyclicality by selling proprietary products that cannot be easily or quickly replaced, to a geographically diverse base of customers across a broad range of

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market segments. However, we have experienced substantial period-to-period fluctuations in operating results and expect, in the future, to experience period-to-period fluctuations in operating results due to general industry or economic conditions.

We are exposed to various risks related to legal proceedings or claims.

We have in the past, are currently, and in the future may be, involved in legal proceedings or claims regarding patent infringement, intellectual property rights, contracts or other matters. As is typical in the semiconductor industry, from time to time, we may receive letters from various industry participants alleging infringement of patents or trade secrets. We typically respond when appropriate and as advised by legal counsel. Any lawsuits resulting from such allegations could subject us to significant liability for damages and invalidate our proprietary rights. We also receive notifications from customers from time to time who believe that we owe them indemnification or other obligations related to infringement claims made against the customers by third parties. These legal proceedings and claims, whether with or without merit, could result in substantial cost to us and divert our resources. If we are not able to resolve a claim, negotiate a settlement of a matter, obtain necessary licenses on commercially reasonable terms, and/or successfully prosecute or defend our position, we could incur uninsured liability in any one of them and our business, financial condition or results of operations could be harmed.

It is also possible that from time to time we may be subject to warranty or product liability claims that could lead to significant expenses related to the defense of such claims or any requirement to pay damages claims. We do have product liability insurance, but there is no certainty that insurance will cover all claims or be of a sufficient amount to fully protect against such claims. Costs or payments we may make in connection with warranty or product liability claims may adversely affect the results of our operations.

Failure to adequately protect our intellectual property could result in lost revenue or market opportunities.

Our ability to obtain patents, licenses and other intellectual property rights covering our products and manufacturing processes is important for our success. To that end, we have acquired certain patents and patent licenses and intend to continue to seek patents on our inventions and manufacturing processes. The process of seeking patent protection can be long and expensive, and patents may not be issued from currently pending or future applications. In addition, our existing patents and any new patents that are issued may not be of sufficient scope or strength to provide meaningful protection or any commercial advantage to us. We may be subject to or may initiate interference proceedings in the U.S. Patent and Trademark Office, which can require significant financial and management resources. In addition, the laws of certain foreign countries do not protect our intellectual property rights to the same extent as the laws of the United States. Infringement of our intellectual property rights by a third party could result in uncompensated lost market and revenue opportunities for us.

We do not have long-term contracts with our customers.

We do not typically enter into long-term contracts with our customers and we cannot be certain about future order levels from our customers. When we do enter into customer contracts, the contract is generally cancelable at the convenience of the customer. In the event of any early termination of a contract by one of our major customers, it is unlikely that we would be able to rapidly replace that revenue source which could harm our financial results.

Business interruptions could harm our business.

Operations at any of our manufacturing facilities, or at any of our wafer fabrication or test and assembly subcontractors, may be disrupted for reasons beyond our control, including work stoppages, power loss, incidents of terrorism or security risk, political instability, public health issues, telecommunications, transportation or other infrastructure failure, fire, earthquake, floods, or other natural disasters. If operations at any of our facilities, or our subcontractors' facilities are interrupted, we may not be able to shift production to other facilities on a timely basis. If this occurs, we would likely experience delays in shipments of products to our customers and alternate sources for production may be unavailable on acceptable terms. This could result in reduced revenues and profits

and the cancellation of orders or loss of customers. In addition, business interruption insurance will likely not be enough to compensate us for any losses that may occur and any losses or damages incurred by us as a result of business interruptions could significantly harm our business.

We are highly dependent on foreign sales and operations, which exposes us to foreign political and economic risks.

Sales to foreign customers account for a substantial portion of our net sales. During fiscal 2005 and the first six months of fiscal 2006, approximately 73% of our net sales were made to foreign customers. We purchase a substantial portion of our raw materials and equipment from foreign suppliers. In addition, we own product assembly and testing facilities located near Bangkok, Thailand. We also use various foreign third-party contractors for a portion of our assembly and testing and for a portion of our wafer fabrication requirements. Substantially all of our finished goods inventory is maintained in Thailand.

Our reliance on foreign operations, foreign suppliers, maintenance of substantially all of our finished goods in inventory at foreign locations and significant foreign sales exposes us to foreign political and economic risks, including:

- political, social and economic instability
- trade restrictions and changes in tariffs
- import and export license requirements and restrictions
- difficulties in staffing and managing international operations
- employment regulations
- disruptions in international transport or delivery
- fluctuations in currency exchange rates
- difficulties in collecting receivables
- public health conditions
- economic slowdown in the worldwide markets served by us, and
- potentially adverse tax consequences.

If any of these risks materialize, our sales could decrease and our operating results could suffer.

We are subject to stringent environmental regulations, which may force us to incur significant expenses.

We must comply with many different federal, state and local governmental regulations related to the use, storage, discharge and disposal of toxic, volatile or otherwise hazardous chemicals used in our manufacturing process. Although we believe that our activities conform to presently applicable environmental regulations, our failure to comply with present or future regulations could result in the imposition of fines, suspension of production or a cessation of operations. Any such environmental regulations could require us to acquire costly equipment or to incur other significant expenses to comply with such regulations. Any failure by us to control the use of or adequately restrict the discharge of hazardous substances could subject us to future liabilities. Environmental problems may occur that could subject us to future costs or liabilities.

Further, certain of our customers shipping their products into European markets are also subject to governmental environmental regulations such as the Restriction of Hazardous Substances in Electrical and Electronic Equipment Directive (RoHS) which will be effective July 1, 2006, and the Directive on Waste Electrical and Electronic Equipment. These directives focus on limiting the amounts of certain elements, such as lead, in electrical devices, and providing for the proper disposal of the electrical devices and their components. The inability of this sub-set of our customers to use Microchip products which contain lead after July 2006 may adversely affect our results of operations.

Changes in securities laws and related regulations in recent years have resulted in increased costs to us.

Changes in the laws and regulations affecting public companies, including the provisions of the Sarbanes-Oxley Act of 2002 and rules enacted in recent years by the SEC, NASDAQ and the NYSE, have resulted in significantly increased costs to us as we respond to their requirements. In particular, complying with the internal

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control audit requirements of Sarbanes-Oxley Section 404 has resulted in increased internal efforts and significantly higher fees from our independent accounting firm.

Our fiscal 2005 Annual Report on Form 10-K contained a report by our management on our internal control over financial reporting including an assessment of the effectiveness of our internal control over financial reporting as of March 31, 2005. Our fiscal 2005 Form 10-K also contained an attestation and report by our auditors with respect to our management's assessment of the effectiveness of internal control over financial reporting under Section 404. While these assessments and reports did not reveal any material weaknesses in our internal control over financial reporting, compliance with Section 404 is an ongoing process and will be required for each future fiscal year. We expect that the ongoing compliance with Section 404 will continue to be both very costly and very challenging and there can be no assurance that material weaknesses will be identified in future periods. Any adverse results from such ongoing compliance efforts could result in a loss of investor confidence in our financial reports and have an adverse effect on our stock price.

Recent regulations related to equity compensation could adversely affect our earnings and our ability to attract and retain key personnel.

Since our inception, we have used stock options and other long-term equity incentives as a fundamental component of our employee compensation packages and have accounted for them using the intrinsic value method of APB No. 25, "Accounting for Stock Issued to Employees." We believe that stock options and other long-term equity incentives directly motivate our employees to maximize long-term stockholder value and, through the use of vesting, encourage employees to remain with Microchip. In December 2004, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 123 (SFAS 123) (revised 2004), "Share-Based Payments" (SFAS 123R), which changed U.S. Generally Accepted Accounting Principles in such a way to require us to record a charge to earnings for the fair value of employee stock option grants and other share based compensation beginning in the first quarter of fiscal 2007. This regulation will negatively impact our earnings for those share based awards that vest beginning in fiscal 2007. For example, recording a charge for employee stock options under SFAS 123 would have decreased our net income by \$37.2 million in fiscal 2005 and by \$9.3 million in the first six months of fiscal 2006. The impact on net income of SFAS 123R may differ significantly than the impact as calculated under SFAS 123. Furthermore, adoption of SFAS 123R will require us to make certain assumptions and judgments in the valuation of stock options that we may grant in the future. A change in any of those assumptions or judgments could change the compensation expense that is charged against our earnings and, consequently, adversely affect our results of operations. See also Note 3 to the Condensed Consolidated Financial Statements – Share-Based Payment.

In addition, regulations implemented by NASDAQ requiring shareholder approval for all stock option plans as well as regulations implemented by the New York Stock Exchange prohibiting NYSE member organizations from giving a proxy to vote on equity-compensation plans unless the beneficial owner of the shares has given voting instructions could make it more difficult for us to grant equity-based awards to employees in the future. To the extent that these or other new regulations make it more difficult or expensive to grant options to employees, we may incur compensation costs, productivity losses, change our equity compensation strategy or find it difficult to attract, retain and motivate employees, each of which could materially and adversely affect our business.

The future trading price of our common stock could be subject to wide fluctuations in response to a variety of factors.

The market price of our common stock has fluctuated significantly in the past and is likely to fluctuate in the future. The future trading price of our common stock could be subject to wide fluctuations in response to a variety of factors, many of which are beyond our control, including:

- quarterly variations in our operating results and the operating results of other technology companies
- actual or anticipated announcements of technical innovations or new products by us or our competitors
- changes in analysts' estimates of our financial performance or buy/sell recommendations

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- changes in our financial guidance or our failure to meet such guidance
- general conditions in the semiconductor industry, and
- worldwide economic and financial conditions.

In addition, the stock market has experienced significant price and volume fluctuations that have particularly affected the market prices for many high technology companies and that often have been unrelated to the operating performance of such companies. These broad market fluctuations and other factors may harm the market price of our common stock.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Our investment portfolio, consisting of fixed income securities that we hold on an available-for-sale basis, was \$896.1 million as of September 30, 2005. This amount includes securities with original maturities that are within 90 days when acquired and are classified as cash and cash equivalents on our balance sheet. The securities in our investment portfolio, like all fixed income instruments, are subject to interest rate and credit risk and will decline in value if market interest rates increase. We have the ability to hold our fixed income investments until maturity and, therefore, we would not expect to recognize any material adverse impact in income or cash flows if market interest rates increase. The following table provides information about our available-for-sale securities that are sensitive to changes in interest rates. We have aggregated our available-for-sale securities for presentation purposes since they are all very similar in nature (dollars in thousands):

	Financial instruments mature during the fiscal year ended March 31,					
	2006	2007	2008	2009	2010	Thereafter
Available-for-sale securities	\$ 169,508	\$ 81,554	\$ 103,928	\$ 193,293	\$ 209,152	\$ 34,975

Weighted-average yield rate	3.28%	2.74%	3.17%	3.62%	4.20%	3.76%
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We have international operations and are thus subject to foreign currency rate fluctuations. To date, our exposure related to exchange rate volatility has not been significant. Approximately 99% of our sales are denominated in U.S. dollars. At times we maintain hedges of foreign currency exposure of a net investment in a foreign operation. There were no foreign currency hedges outstanding as of September 30, 2005. If foreign currency rates fluctuate by 15% from the rates at September 30, 2005, the effect on our financial position and results of operation would not be material.

During the normal course of business we are routinely subjected to a variety of market risks, examples of which include, but are not limited to, interest rate movements and foreign currency fluctuations, as we discuss in this Item 3, and collectability of accounts receivable. We continuously assess these risks and have established policies and procedures to protect against the adverse effects of these and other potential exposures. Although we do not anticipate any material losses in these risk areas, no assurance can be made that material losses will not be incurred in these areas in the future.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

As of the end of the period covered by this Quarterly Report on Form 10-Q, as required by paragraph (b) of Rule 13a-15 or Rule 15d-15 under the Securities Exchange Act of 1934, as amended, we evaluated under the supervision of our Chief Executive Officer and our Chief Financial Officer, the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) or 15d-15(e) of the Securities Exchange Act of 1934, as amended). Based on this evaluation, our Chief Executive Officer and our Chief Financial Officer have concluded that our disclosure controls and procedures are effective to ensure that information we are required to disclose in reports that we file or submit under the Securities Exchange Act of 1934 (i) is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms, and (ii) is accumulated and communicated to our management, including our Chief Executive Officer and our Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure. Our disclosure controls

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and procedures are designed to provide reasonable assurance that such information is accumulated and communicated to our management. Our disclosure controls and procedures include components of our internal control over financial reporting. Management's assessment of the effectiveness of our internal control over financial reporting is expressed at the level of reasonable assurance because a control system, no matter how well designed and operated, can provide only reasonable, but not absolute, assurance that the control system's objectives will be met.

Changes in Internal Control over Financial Reporting

During the three months ended September 30, 2005, there was no change in our internal control over financial reporting identified in connection with the evaluation required by paragraph (d) of Rule 13a-15 or Rule 15d-15 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Part II. OTHER INFORMATION

Item 1. Legal Proceedings

In the ordinary course of our business, we are involved in a limited number of legal actions, both as plaintiff and defendant, and could incur uninsured liability in any one or more of them. Although the outcome of these actions is not presently determinable, we believe that the ultimate resolution of these matters will not harm our business and will not have a material adverse effect on our financial position, cash flows or results of operations. Litigation relating to the semiconductor industry is not uncommon, and we are, and from time to time have been, subject to such litigation. No assurances can be given with respect to the extent or outcome of any such litigation in the future.

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

We did not repurchase any shares of our common stock under our repurchase program during the second quarter of fiscal 2006.

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

- (a) We held our Annual Meeting of Stockholders on August 15, 2005.
- (b) Steve Sanghi, Albert J. Hugo-Martinez, L.B. Day, Matthew W. Chapman and Wade F. Meyercord were elected as directors at the Annual Meeting.
- (c) The results of the vote on the matters voted upon at the Annual Meeting were as follows:

(1) *Election of Directors:*

Director	For	Withheld/Abstain
Steve Sanghi	189,111,133	4,357,604
Albert J. Hugo-Martinez	189,670,299	3,798,438
L.B. Day	179,590,409	13,878,328
Matthew W. Chapman	192,685,457	783,280
Wade F. Meyercord	192,577,123	891,614

(2) *Approval of the ratification of the appointment of Ernst & Young LLP as the independent registered public accounting firm of Microchip for the fiscal year ending March 31, 2006:*

For	Against	Withheld/Abstain	Broker Non-Votes
192,811,980	596,287	60,470	-0-

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The foregoing matters are described in more detail in our definitive proxy statement dated July 11, 2005.

Item 6. Exhibits

Exhibit 31	Certification of Chief Executive Officer and Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
Exhibit 32	Certification of Chief Executive Officer and Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

SIGNATURES

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

MICROCHIP TECHNOLOGY INCORPORATED

Date: November 4, 2005

By: /s/ Gordon W. Parnell

Gordon W. Parnell
Vice President and Chief Financial Officer
(Duly Authorized Officer, and
Principal Financial and Accounting Officer)

CERTIFICATION

I, Steve Sanghi, certify that:

1. I have reviewed, this Form 10-Q of Microchip Technology 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 Exchange Act Rules 13a-15(f) 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 reporting 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; and
 - (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 the registrant's board of directors (or persons performing the equivalent functions):
 - (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 4, 2005

/s/ Steve Sanghi
Steve Sanghi
President and CEO

CERTIFICATION

I, Gordon Parnell, certify that:

1. I have reviewed, this Form 10-Q of Microchip Technology 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 Exchange Act Rules 13a-15(f) 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 reporting 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; and
 - (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 the registrant's board of directors (or persons performing the equivalent functions):
- (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 4, 2005

/s/ Gordon W. Parnell
Gordon W. Parnell
Vice President and CFO

**CERTIFICATION OF CHIEF EXECUTIVE OFFICER AND CHIEF FINANCIAL OFFICER
PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

I, Steve Sanghi, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that the Quarterly Report of Microchip Technology Incorporated on Form 10-Q for the quarterly period ended September 30, 2005 fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and that information contained in such Form 10-Q fairly presents, in all material respects, the financial condition and results of operations of Microchip Technology Incorporated.

By: /s/ Steve Sanghi
Name: Steve Sanghi
Title: President and Chief Executive Officer
Date: November 4, 2005

I, Gordon W. Parnell, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that the Quarterly Report of Microchip Technology Incorporated on Form 10-Q for the quarterly period ended September 30, 2005 fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and that information contained in such Form 10-Q fairly presents, in all material respects, the financial condition and results of operations of Microchip Technology Incorporated.

By: /s/ Gordon W. Parnell
Name: Gordon W. Parnell
Title: Vice President and Chief Financial Officer
Date: November 4, 2005
