

MEMSIC Inc  
Form 10-Q  
November 14, 2008  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**FORM 10-Q**

(Mark One)

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the quarterly period ended September 30, 2008

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 No. 001-33813

**MEMSIC, Inc.**

(Exact name of registrant as specified in its charter)

**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

**04-3457049**  
(I.R.S. Employer Identification No.)

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**One Tech Drive, Suite 325**  
**Andover, Massachusetts**  
(Address of principal executive offices)

**(978) 738-0900**

**01810**  
(Zip Code)

(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer, or a smaller reporting company. See definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company

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

The number of shares of common stock, par value \$.00001 per share, of the registrant outstanding as of November 10, 2008 was 23,790,225.

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**MEMSIC, Inc.**

**FORM 10-Q, September 30, 2008**

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**Table of Contents****PART I. FINANCIAL INFORMATION****Item 1. Financial Statements****MEMSIC, Inc.****CONDENSED CONSOLIDATED BALANCE SHEETS****(Unaudited)**

|  | <b>September 30,<br/>2008</b> | <b>December 31,<br/>2007</b> |
|--|-------------------------------|------------------------------|
| <b>ASSETS</b>  |                               |                              |
| Current assets:  |                               |                              |
| Cash and cash equivalents  | \$ 64,222,262                 | \$ 20,708,794                |
| Short-term investments   |                               | 46,925,000                   |
| Accounts receivable, net of allowance for doubtful accounts of \$8,503 as of September 30, 2008 and December 31, 2007  | 3,110,078                     | 5,917,457                    |
| Inventories  | 7,460,148                     | 5,614,050                    |
| Deferred taxes   | 589,490                       | 497,408                      |
| Other assets   | 1,911,742                     | 1,090,513                    |
| <b>Total current assets</b>  | <b>77,293,720</b>             | <b>80,753,222</b>            |
| Property and equipment, net  | 12,383,971                    | 7,677,774                    |
| Long-term investments  | 5,800,000                     |                              |
| Other assets   | 1,236,230                     | 420,568                      |
| <b>Total assets</b>  | <b>\$ 96,713,921</b>          | <b>\$ 88,851,564</b>         |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b>   |                               |                              |
| Current liabilities:   |                               |                              |
| Accounts payable   | \$ 588,165                    | \$ 2,224,349                 |
| Accrued expenses   | 1,683,450                     | 2,189,583                    |
| Note payable   |                               | 1,000,000                    |
| <b>Total current liabilities</b>   | <b>2,271,615</b>              | <b>5,413,932</b>             |
| Stockholders' equity   |                               |                              |
| Common stock, \$0.00001 par value; authorized, 100,000,000 shares; 23,790,100 and 22,768,600 shares issued and outstanding at September 30, 2008 and December 31, 2007, respectively | 238                           | 228                          |
| Additional paid-in capital   | 96,427,827                    | 87,176,262                   |
| Accumulated other comprehensive income   | 2,581,832                     | 1,063,747                    |
| Accumulated deficit  | (4,567,591)                   | (4,802,605)                  |
| <b>Total stockholders' equity</b>  | <b>94,442,306</b>             | <b>83,437,632</b>            |
| <b>Total liabilities and stockholders' equity</b>  | <b>\$ 96,713,921</b>          | <b>\$ 88,851,564</b>         |

See accompanying notes to condensed consolidated financial statements (unaudited)

**Table of Contents****MEMSIC, Inc.****CONSOLIDATED STATEMENTS OF OPERATIONS****(Unaudited)**

|  | Three Months Ended<br>September 30, |              | Nine Months Ended<br>September 30, |               |
|--|-------------------------------------|--------------|------------------------------------|---------------|
|  | 2008                                | 2007         | 2008                               | 2007          |
| Net sales  | \$ 5,015,422                        | \$ 9,328,016 | \$ 14,877,460                      | \$ 18,768,590 |
| Cost of goods sold   | 2,443,262                           | 3,280,250    | 7,638,592                          | 6,448,609     |
| Gross profit   | 2,572,160                           | 6,047,766    | 7,238,868                          | 12,319,981    |
| Operating expenses:  |                                     |              |                                    |               |
| Research and development   | 861,484                             | 969,133      | 2,618,703                          | 2,411,288     |
| Sales and marketing  | 771,870                             | 843,168      | 2,201,479                          | 2,099,650     |
| General and administrative   | 1,705,150                           | 1,094,466    | 4,466,613                          | 2,640,794     |
| Total operating expenses   | 3,338,504                           | 2,906,767    | 9,286,795                          | 7,151,732     |
| Operating income (loss)  | (766,344)                           | 3,140,999    | (2,047,927)                        | 5,168,249     |
| Other income (expense):  |                                     |              |                                    |               |
| Interest and dividend income   | 514,621                             | 173,085      | 1,734,848                          | 483,710       |
| Interest expense   | (49)                                | (22,751)     | (24,382)                           | (22,751)      |
| Other, net   | 218,400                             | 14,794       | 382,838                            | 32,004        |
| Total other income (expense)   | 732,972                             | 165,128      | 2,093,304                          | 492,963       |
| Earnings (loss) before income taxes  | (33,372)                            | 3,306,127    | 45,377                             | 5,661,212     |
| Provision (benefit) for income taxes   | (164,494)                           | 527,743      | (189,637)                          | 958,131       |
| Net income   | \$ 131,122                          | \$ 2,778,384 | \$ 235,014                         | \$ 4,703,081  |
| Net income available to common stockholders:   |                                     |              |                                    |               |
| Basic  | \$ 131,122                          | 352,845      | \$ 235,014                         | 505,509       |
| Diluted  | \$ 131,122                          | 426,643      | \$ 235,014                         | 578,212       |
| Net income per common share:   |                                     |              |                                    |               |
| Basic  | \$ 0.01                             | \$ 0.14      | \$ 0.01                            | \$ 0.21       |
| Diluted  | \$ 0.01                             | \$ 0.14      | \$ 0.01                            | \$ 0.20       |
| Weighted average shares outstanding used in calculating net income per common share: |                                     |              |                                    |               |
| Basic  | 23,789,899                          | 2,476,562    | 23,654,292                         | 2,413,645     |
| Diluted  | 23,884,400                          | 3,109,066    | 23,883,286                         | 2,830,894     |

See accompanying notes to condensed consolidated financial statements (unaudited)



**Table of Contents****MEMSIC, Inc.****CONSOLIDATED STATEMENTS OF CASH FLOWS****(Unaudited)**

|  | <b>Nine Months Ended<br/>September 30,</b> |                     |
|--|--|---------------------|
|  | <b>2008</b>                                | <b>2007</b>         |
| <b>Cash flows from operating activities:</b>   |  |                     |
| Net income   | \$ 235,014                                 | \$ 4,703,081        |
| <b>Adjustments to reconcile net income to cash provided by operating activities:</b> |  |                     |
| Depreciation and amortization  | 1,184,557                                  | 693,061             |
| Stock compensation expense   | 964,071                                    | 406,209             |
| Excess tax benefit from stock-based compensation arrangement                         | (95,955)                                   |                     |
| Deferred income taxes  | (80,166)                                   | 543,200             |
| Forgiveness of stockholder loan  |  | 41,972              |
| <b>Changes in assets and liabilities:</b>  |  |                     |
| Accounts receivable  | 2,807,379                                  | (2,185,519)         |
| Inventories  | (1,243,445)                                | (1,909,085)         |
| Other assets   | (760,425)                                  | (636,740)           |
| Accounts payable and accrued expenses  | (2,066,482)                                | 1,502,712           |
| Deferred revenue   |  | (1,139,170)         |
| <b>Net cash provided by operating activities</b>                                     | <b>944,548</b>                             | <b>2,019,721</b>    |
| <b>Cash flows from investing activities:</b>   |  |                     |
| Purchase of short-term investments   | (18,700,000)                               | (11,625,000)        |
| Proceeds from sale of short-term investments   | 59,825,000                                 | 10,975,000          |
| Purchase of property and equipment   | (4,872,187)                                | (3,721,922)         |
| Decrease in restricted cash  |  | 250,646             |
| <b>Net cash provided by (used in) investing activities</b>                           | <b>36,252,813</b>                          | <b>(4,121,276)</b>  |
| <b>Cash flows from financing activities:</b>   |  |                     |
| Offering costs incurred related to initial public offering                           | (591,100)                                  | (1,333,090)         |
| Proceeds from exercise of underwriter's over-allotment to purchase common stock      | 8,230,000                                  |                     |
| Proceeds from (payments of) notes payable  | (1,000,000)                                | 899,904             |
| Net proceeds from sale of convertible preferred stock                                |  | 600,000             |
| Proceeds from exercise of options to purchase common stock                           | 43,450                                     | 202,563             |
| Excess tax benefit from stock-based compensation arrangement                         | 95,955                                     |                     |
| Collection of stockholder loans receivable   |  | 4,000               |
| <b>Net cash provided by financing activities</b>                                     | <b>6,778,305</b>                           | <b>373,377</b>      |
| Effect of exchange rate changes on cash and cash equivalents                         | (462,198)                                  | 51,342              |
| <b>Net increase (decrease) in cash and cash equivalents</b>                          | <b>43,513,468</b>                          | <b>(1,676,836)</b>  |
| Cash and cash equivalents beginning of period  | 20,708,794                                 | 7,141,813           |
| <b>Cash and cash equivalents end of period</b>                                       | <b>\$ 64,222,262</b>                       | <b>\$ 5,464,977</b> |
| <b>Supplemental non-cash financing and investing activities:</b>                     |  |                     |
| Acquisition of intangible asset in exchange for common stock                         | \$ 509,200                                 | \$                  |

See accompanying notes to condensed consolidated financial statements (unaudited)





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**MEMSIC, Inc.**

**Notes to Unaudited, Condensed Consolidated Financial Statements**

**1. NATURE OF THE BUSINESS AND OPERATIONS**

MEMSIC, Inc. (the Company) was incorporated on March 3, 1999 as a Delaware corporation. The Company is a leading provider of semiconductor sensor systems solutions based on micro electromechanical systems (MEMS) technology and advanced integrated circuit design. The Company has integrated MEMS technology-based inertial sensors, commonly known as accelerometers, with mixed signal processing circuitry onto a single chip using a standard complementary metal-oxide-semiconductor (CMOS) process. This proprietary technology has allowed for sensor solutions at lower cost, higher performance and improved functionality. Utilizing a standard CMOS process allows easily integrated additional functions, the creation of new sensors to expand into magnetic, touch and flow sensors, as well as other MEMS application areas beyond accelerometers. Any application that requires the control or measurement of motion is a potential application for accelerometers. Accelerometer products have a wide range of applications for consumer electronics, mobile phones, automotive (airbags, rollover detection, electronic stability control and navigation systems), as well as business, industrial and medical applications.

MEMSIC, Inc. maintains its corporate headquarters in Massachusetts. All manufacturing operations are provided by its wholly-owned subsidiary, MEMSIC Semiconductor (Wuxi) Company Limited (MEMSIC Semiconductor), located in the People's Republic of China (PRC).

**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICES**

***Principles of Consolidation***

The accompanying unaudited consolidated financial statements include the accounts of MEMSIC, Inc. and MEMSIC Semiconductor. All significant intercompany balances and transactions have been eliminated in consolidation.

***Unaudited Interim Financial Information***

The accompanying interim consolidated financial statements are unaudited. These financial statements and notes should be read in conjunction with the audited consolidated financial statements and related notes, together with the management's discussion and analysis of financial condition and results of operations, contained in the Company's Annual Report on Form 10-K for the year ended December 31, 2007, which is on file with the Securities and Exchange Commission (SEC).

The accompanying unaudited interim consolidated financial statements have been prepared pursuant to the rules and regulations of the SEC. Certain information and footnote disclosures normally included in financial statements that have been prepared in accordance with accounting principles generally accepted in the United States (GAAP) have been condensed or omitted pursuant to such SEC rules and regulations. In the opinion of management, the unaudited interim consolidated financial statements and notes have been prepared on the same basis as the audited consolidated financial statements in the Company's Annual Report on Form 10-K for the year ended December 31, 2007, and include all adjustments (consisting of normal, recurring adjustments) necessary for the fair presentation of the Company's financial position at September 30, 2008, results of operations for the three and nine months ended September 30, 2008 and 2007 and cash flows for the nine months ended September 30, 2008 and 2007. The interim periods are not necessarily indicative of results to be expected for any other interim periods or for the full year.

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### ***Use of Estimates***

The preparation of financial statements in conformity with United States GAAP requires the Company to make estimates and assumptions that affect at the date of the financial statements the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities and the reported amounts of revenue and expenses. Actual results could differ from these estimates.

### ***Cash Equivalents***

The Company considers all highly liquid instruments with an original maturity of three months or less to be cash equivalents.

### ***Foreign Currency***

The Company's manufacturing operations and certain other operations are conducted by MEMSIC Semiconductor. The functional currency of MEMSIC Semiconductor is the Renminbi. Financial transactions between the Company and MEMSIC Semiconductor are conducted in United States dollars. At September 30, 2008 and December 31, 2007, the underlying currency for approximately 38.0% and 19.6% of consolidated assets, respectively, was the Renminbi. The Company does not believe that it is subject to significant foreign exchange risk and, accordingly, has not utilized hedging strategies with respect to such foreign exchange exposure.

The financial statements of MEMSIC Semiconductor are translated into United States dollars in accordance with Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards (SFAS) No. 52, *Foreign Currency Translation*. The functional currency of MEMSIC Semiconductor, the Renminbi, is translated into United States dollars utilizing the following method: assets and liabilities are translated at the exchange rate in effect at the end of the period, and revenues and expenses are translated at the weighted average exchange rate during the year. Cumulative translation gains and losses are included as a separate component of stockholders' equity and reported as a part of comprehensive income. Transaction gains and losses are included in the consolidated statements of operations as incurred.

### ***Fair Value of Financial Instruments***

The carrying amounts of the Company's financial instruments, which include cash equivalents, short-term investments, accounts receivable, accounts payable, notes payable and accrued expenses, approximate their fair values due to the short-term nature of the instruments.

### ***Net Income per Common Share***

Basic net income per share is calculated by dividing net income by the weighted-average common shares outstanding. Diluted net income per share is calculated by dividing net income by the weighted-average common shares and potentially dilutive securities outstanding during the period using the treasury stock method.

As of December 19, 2007, the effective date of the Company's IPO, the Company transitioned from having two classes of equity securities outstanding, common and preferred stock, to a single class of common stock. For the period prior to December 19, 2007, the Company calculated net income (loss) per share in accordance with SFAS No. 128, *Earnings Per Share*, as clarified by Emerging Issues Task Force (EITF) Issue No. 03-6, *Participating Securities and the Two-Class Method Under FASB Statement No. 128, Earnings Per Share*. EITF No. 03-6 clarifies the use of the two-class method of calculating earnings per share, or EPS, as originally prescribed in SFAS No. 128. Under the two-class method, basic net income (loss) per share is computed by dividing the net income (loss) available to common stockholders by the weighted-average number of common shares outstanding during the period. Diluted net income (loss) per share is computed using the more dilutive of (a) the two-class method, or (b) the if-converted method. The Company allocates net income first to convertible preferred stockholders based on dividend participation rights under the Company's Certificate of Incorporation and then to convertible preferred and common stockholders based on ownership interests. Net losses are not allocated to convertible preferred stockholders.

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### ***Income Taxes***

Deferred tax assets and liabilities relate to temporary differences between the financial reporting basis and the tax basis of assets and liabilities, the carryforward tax losses and available tax credits. Such assets and liabilities are measured using tax rates and laws expected to be in effect at the time of their reversal or utilization. Valuation allowances are established, when necessary, to reduce the net deferred tax asset to an amount more likely than not to be realized. For interim reporting periods, the Company uses the estimated annual effective tax rate except with respect to discrete items, whose impact is recognized in the interim period in which the discrete item occurred.

### ***Inventories***

Inventories are stated at the lower of cost (weighted average FIFO) or market. The Company evaluates its inventory for potential excess and obsolete inventories based on forecasted demands and records a provision for such amounts as necessary. The Company recorded a provision of \$64,502 in the third quarter of 2008 and \$0 in 2007.

### ***Revenue Recognition***

The Company recognizes revenue from the sale of its product to its customers when all of the following conditions have been met: (i) evidence exists of an arrangement with the customer, typically consisting of a purchase order or contract; (ii) the Company's products have been shipped and risk of loss has passed to the customer; (iii) the Company has completed all of the necessary terms of the purchase order or contract; (iv) the amount of revenue to which the Company is entitled is fixed or determinable; and (v) the Company believes it is probable that it will be able to collect the amount due from the customer based upon an evaluation of the customer's creditworthiness. To the extent that one or more of these conditions has not been satisfied, the Company defers recognition of revenue. An allowance for estimated future product returns and sales price allowances is established at the date of revenue recognition. An allowance for uncollectible receivables is established by a charge to operations when, in the opinion of the Company, it is probable that the amount due to the Company will not be collected.

The Company sells its products to distributors as well as to end customers. Sales to distributors account for a significant amount of the Company's revenue. Sales to distributors are made pursuant to distributor agreements, which allow for the return of goods under certain circumstances. Accordingly, the Company follows the provisions of SFAS No. 48, *Revenue Recognition When Right of Return Exists*. SFAS No. 48 includes the following criteria for recognition of sales to distributors: (i) the selling price to the distributor is fixed or determinable at the date of shipment; (ii) the distributor's obligation to pay the selling price is not contingent on resale of the product; (iii) the Company's product has been shipped and risk of loss has passed to the distributor; (iv) it is probable that the amount due from the distributor will be collected; (v) the Company does not have significant future obligations to directly assist in the distributor's resale of the product; and (vi) the amount of future returns can be reasonably estimated. Once these criteria are met, the Company recognizes revenue upon shipment to the distributor and estimates returns based on historical sales returns.

The Company has a significant distributor for which the criteria under SFAS No. 48 had not been met for periods prior to August 30, 2007. Based on the early stage of the relationship with this distributor and its size, the Company was unable to make a reasonable estimate of future returns. Therefore, the Company deferred recognition of revenue and related product costs associated with sales to this distributor until the product was shipped to the distributor's end customers. Deferred revenue at June 30, 2007 amounted to \$2.0 million. On August 30, 2007, the Company amended the agreement with the distributor to allow for returns only upon the Company's approval. Accordingly, the criteria under SFAS No. 48 have been met for this distributor as of August 30, 2007, and the Company recognizes revenue upon shipment to this distributor for all shipments made on or after August 30, 2007 based on shipments to this distributor. For all shipments through this distributor made prior to August 30, 2007, the Company continued to recognize its revenue upon shipments to the end customers. At December 31, 2007, all such shipments made to this distributor prior to August 30, 2007 had been sold by this distributor to end customers and therefore, there was no remaining deferred revenue at that date.

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During the second quarter of 2008, the Company reversed \$2.0 million in revenue from the sale of printed circuit boards that were shipped and sold in the first quarter of 2008 for use in the Olympic torch project. Problems experienced by the Company's customer, due in part to the recent earthquake in China, prevented the timely commercial introduction of the Olympic torch, and the customer invoked a clause in its contract with MEMSIC that permitted the customer to suspend the project in the event of a natural disaster such as an earthquake. As a result, the Company reversed the previously recognized revenue and the related account receivable in the second quarter.

***Stock-Based Compensation***

In December 2004, the FASB issued SFAS No. 123 (revised 2004), *Share-Based Payment* (SFAS No. 123(R)), which replaces SFAS No. 123, *Accounting for Stock-Based Compensation* (SFAS No. 123), and supersedes Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees* (APB 25). SFAS No. 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values beginning with the first annual period after December 15, 2005. SFAS No. 123(R) requires that an entity measure the cost of equity-based service awards based on the grant-date fair value of the award and recognize the cost of such award over the period during which the employee is required to provide service in exchange for the award (vesting period). The pro forma disclosures previously permitted under SFAS No. 123 are no longer an alternative to financial statement recognition. The Company adopted SFAS No. 123(R) on January 1, 2006 using the prospective transition method, which required that all new stock-based awards granted subsequent to adoption be recognized in the financial statements at fair value.

Stock-based compensation arrangements with non-employees are accounted for utilizing the fair value method or, if a more reliable measurement, the value of the services or consideration received. The resulting compensation expense is recognized for financial reporting over the term of performance or vesting.

***Recent Accounting Pronouncements***

In December 2007, the FASB issued SFAS 141R, *Business Combinations* (SFAS 141R). This statement is to improve the relevance, representational faithfulness, and comparability of the information that a reporting entity provides in its financial reports about a business combination and its effects. This statement is effective prospectively for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115* (SFAS 159). SFAS 159 permits entities to choose to measure financial instruments and certain other items at fair value. Unrealized gains and losses on items for which the fair value option has been elected will be recognized in earnings at each subsequent reporting date. This statement is effective for financial statements issued for fiscal years beginning after November 15, 2007. SFAS 159 was effective for the Company on January 1, 2008. The adoption of the provisions of SFAS 159 did not have any impact on the Company's financial position and results of operations.

In April 2008, the FASB issued FASB Staff Position (FSP) 142-3, *Determination of the Useful Life of Intangible Assets*, which amends the factors that must be considered in developing renewal or extension assumptions used to determine the useful life over which to amortize the cost of a recognized intangible asset under SFAS No. 142. The FSP is effective for financial statements for fiscal years beginning after December 15, 2008. The Company is currently evaluating the impact that the adoption of this FSP will have on its consolidated financial statements.

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Investments held by the Company at September 30, 2008 consisted primarily of auction rate securities, or ARS, and are considered available for sale. These securities reset the interest or dividend rates by auctions held at intervals of 7, 28, 35 or 49 days, and at such dates the Company has the option to sell such securities. The auction rate securities held by the Company have credit quality ratings of at least AAA/Aaa and contractual maturities of greater than 10 years.

These investments are carried at fair value, with the unrealized gains and losses, if any, net of tax, reported in other comprehensive income. The cost of securities sold is based on the specific identification method. Interest and dividends on securities classified as short-term investments are included in interest and dividend income. Quarterly, management reviews the valuation of short-term investments and considers whether any decline in value is deemed to be other than a temporary decline.

At September 30, 2008, the Company held two ARS investments: Illinois Edl Facs Auth Revs Savrs-III College Of Optometry for \$3.0 million and Montana St. Hlth Fac Auth Hosp Rev Savrs Deacon for \$2.8 million. The Company has classified all of the \$5.8 million as long-term assets due to liquidity issues that have recently been experienced in global credit and capital markets as well as failed auctions during 2008. A failed auction means that the amount of securities submitted for sale at auction exceeded the amount of purchase orders. If an auction fails, the issuer becomes obligated to pay interest at penalty rates, and all of the auction rate securities the Company holds continue to pay interest in accordance with their stated terms. However, the failed auctions create uncertainty as to the liquidity of these securities.

Based on the Company's expected operating cash flows, and other sources of cash, the Company does not expect the potential lack of liquidity in these investments to affect its ability to execute its current business plan in the near term.

***Fair Value Measurement***

The Company adopted the provisions of SFAS No. 157, *Fair Value Measurements* (SFAS No. 157) relating to assets and liabilities recognized or disclosed in the financial statements at fair value on a recurring basis on January 1, 2008. The adoption of these provisions did not have a material effect on the Company's consolidated financial statements.

SFAS 157 clarifies that fair value is an exit price, representing the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants based on the highest and best use of the asset or liability. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or liability. SFAS 157 requires the Company to use valuation techniques to measure fair value that maximize the use of observable inputs and minimize the use of unobservable inputs. These inputs are prioritized as follows:

- Level 1: Observable inputs such as quoted prices for identical assets or liabilities in active markets
- Level 2: Other inputs that are observable directly or indirectly, such as quoted prices for similar assets or liabilities or market-corroborated inputs
- Level 3: Unobservable inputs for which there is little or no market data and which require the Company to develop its own assumptions about how market participants would price the assets or liabilities

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The valuation techniques that may be used to measure fair value are as follows:

- A. Market approach - Uses prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities
  - B. Income approach - Uses valuation techniques to convert future amounts to a single present amount based on current market expectations about those future amounts, including present value techniques, option-pricing models and excess earnings method
  - C. Cost approach - Based on the amount that currently would be required to replace the service capacity of an asset (replacement cost)
- The Company's assets measured at fair value on a recurring basis during the period include (in thousands):

|                         | Carrying Amount as of<br>September 30,<br>2008 |       |    | Level 1 | Level 2  | Level 3 | Valuation<br>Technique |
|-------------------------|--|-------|----|---------|----------|---------|------------------------|
| Auction rate securities | \$   | 5,800 | \$ | \$      | \$ 5,800 | (B)     |                        |

The reconciliation of the Company's assets measured at fair value on a recurring basis using unobservable inputs (Level 3) is as follows (in thousands):

|  | Auction Rate<br>Securities |
|--|----------------------------|
| Balance at January 1, 2008             | \$                         |
| Additions                              | \$                         |
| Transfers to Level 3                   | \$5,800                    |
| <i>Gains and losses:</i>               |                            |
| Reported in earnings                   | \$                         |
| Reported in other comprehensive income | \$                         |
| Balance at September 30, 2008          | \$5,800                    |

The Company accounts for the ARS held in its portfolio as available-for-sale investments. The carrying value of these ARS approximated fair value due to the frequent resetting of the interest rate. While the Company continues to earn interest on those investments involved in failed auctions at the specified contractual rate, due to the failed auctions and the illiquidity of these securities under current market conditions, the Company has considered whether par value continues to be a reasonable basis for estimating the fair value of these ARS at September 30, 2008.

The Company therefore estimated the fair value of these securities at September 30, 2008 using broker valuations and internally-developed models of the expected future cash flows related to the securities. One of the more significant assumptions made in the Company's internally-developed models was the term of expected cash flows of the underlying auction rate securities. The Company developed several scenarios for the liquidation of the auction rate securities over periods that ranged from 3 to 15 months. Based on the Company's internal modeling and the value provided by the broker, the Company concluded that the fair value of the auction rate securities approximated the par value as of September 30, 2008.

The Company has also concluded that no other-than-temporary impairment losses on the Company's auction rate securities occurred in the three months ended September 30, 2008. In making this determination, the Company considered the financial condition and near-term prospect of the issuers, the magnitude of the losses compared to the investments' cost, the length of time the investments have been in an unrealized loss position, the low probability that the Company will be unable to collect all amounts due according to the contractual terms of the security, whether the security has been downgraded by a rating agency, and the Company's ability and intent to hold these investments until the

anticipated recovery in market value occurs.

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The Company continues to monitor the market for auction rate securities and consider its impact, if any, on the fair value of the Company's investments. If current market conditions deteriorate further, the Company may be required to record additional temporary unrealized losses in other comprehensive income or, if the decline in fair value is judged to be other-than-temporary, the cost basis of the individual security may be written off to fair value as a new cost basis and the amount of the write-down would be reflected as a charge to earnings.

**4. INVENTORIES**

Inventories consist of the following:

|                 | September 30,<br>2008 | December 31,<br>2007 |
|-----------------|-----------------------|----------------------|
| Raw materials   | \$ 1,957,130          | \$ 1,200,179         |
| Work in process | 3,954,537             | 2,674,165            |
| Finished goods  | 1,548,481             | 1,739,706            |
| Total           | \$ 7,460,148          | \$ 5,614,050         |

**5. STOCK BASED COMPENSATION***Description of Plan*

On March 29, 2000, the Company's stockholders and board of directors approved the 2000 Omnibus Stock Plan (the "2000 Plan"), as amended, under which 2,969,000 shares of the Company's common stock were reserved for issuance to directors, officers, employees, and consultants. Options granted under the 2000 Plan may be incentive stock options, nonqualified stock options and/or restricted stock. The 2000 Plan provides that the exercise price of incentive stock options must be at least equal to the market value of the Company's common stock at the date such option is granted. For incentive stock option grants to an employee who owns more than 10% of the outstanding shares of common stock of the Company, the exercise price on the incentive stock option must be 110% of market value at the time of grant. Granted options expire in ten years or less from the date of grant and vest based on the terms of the awards, generally ratably over four years.

On August 22, 2007, the Company's board of directors approved the 2007 Stock Incentive Plan (the "2007 Plan"), under which up to 3,000,000 shares of the Company's common stock may become available for issuance. At the adoption date, 1,526,425 shares were reserved for issuance. The reserved amount will increase by 300,000 shares at each of the five anniversaries of the adoption date, for a maximum of 3,000,000 shares issuable under the 2007 Plan. Prior to December 19, 2007, there was no public market for the Company's common stock. Accordingly, the board of directors determined the market value of the common stock at the date of grant by considering a number of relevant factors, including the Company's operating and financial performance and corporate milestones achieved, the prices at which shares of convertible preferred stock in arm's-length transactions were sold, the composition of and changes to the management team, the superior rights and preferences of securities senior to the common stock at the time of each grant and the likelihood of achieving a liquidity event for the shares of common stock underlying stock options.

*Valuation of Stock Options*

The Company uses the Black-Scholes option pricing model to calculate the grant-date fair value of an option award. The weighted-average fair values per share of the options granted during the three and nine months ended September 30, 2008 were \$1.45 and \$2.07 respectively, while the weighted-average fair values per share of the options granted during the three and nine months ended September 30, 2007 were \$4.42 and \$4.08 respectively, utilizing the following assumptions:

|                         | Three Months Ended<br>September 30, |      | Nine Months Ended<br>September 30, |         |
|-------------------------|-------------------------------------|------|------------------------------------|---------|
|                         | 2008                                | 2007 | 2008                               | 2007    |
| Volatility              | 65%                                 | 68%  | 64%-65%                            | 65%-68% |
| Expected dividend yield | 0%                                  | 0%   | 0%                                 | 0%      |



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|                                 |         |         |         |         |
|---------------------------------|---------|---------|---------|---------|
| Expected life                   | 5 years | 5 years | 5 years | 5 years |
| Average risk free interest rate | 3.21%   | 5.51%   | 3.11%   | 5.28%   |
| Forfeitures                     | 21.0%   | 27%     | 22%     | 27%     |

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As there was no public market for the Company's common stock prior to the Company's IPO in December 2007, and limited historical information on the volatility of its common stock since the date of the Company's IPO, the Company determined the volatility for options granted in the three and nine months ended September 30, 2008 and 2007 based on an analysis of reported data for a peer group of companies that issued options with substantially similar terms. The expected volatility of options granted has been determined using an average of the historical volatility measures of this peer group of companies for a period equal to the expected life of the option. The Company has not paid and does not anticipate paying cash dividends on its shares of common stock; therefore, the expected dividend yield is assumed to be zero. The expected life of options has been determined utilizing the simplified method as prescribed by the SEC's Staff Accounting Bulletin No. 107, *Share-Based Payment*. The risk-free interest rate is based on a zero coupon United States treasury instrument whose term is consistent with the expected life of the stock options. In addition, SFAS No. 123(R) requires companies to utilize an estimated forfeiture rate when calculating the expense for the period, whereas SFAS No. 123 permitted companies to record forfeitures based on actual forfeitures, which was the Company's historical policy under SFAS No. 123. As a result, the Company applied an estimated forfeiture rate, based on its historical forfeiture experience, in determining the expense recorded in the Company's consolidated statement of operations.

The stock option activity under the 2000 and 2007 Plan for the nine months ended September 30, 2008 is as follows:

|   | Options<br>Outstanding | Weighted<br>Average<br>Exercise Price | Remaining<br>Contractual<br>Term in Years | Aggregate<br>Intrinsic value |
|---|------------------------|---------------------------------------|---|------------------------------|
| Options outstanding at December 31, 2007          | 1,983,293              | \$ 5.99                               |   |                              |
| Granted   | 968,350                | 3.65                                  |   |                              |
| Exercised   | (103,500)              | 0.42                                  |   | \$ 183,215                   |
| Cancelled   | (382,838)              | 6.36                                  |   |                              |
| Options outstanding at September 30, 2008         | 2,465,305              | \$ 5.24                               | 8.7                                       | \$ 792,948                   |
| Options exercisable at September 30, 2008         | 435,355                | \$ 2.41                               | 6.6                                       | \$ 507,861                   |
| Options available for grant at September 30, 2008 | 623,325                |                                       |   |                              |

For the three and nine months ended September 30, 2008 the Company recorded expense of \$320,900 and \$964,070, respectively, in connection with share-based awards, while share-based awards of \$275,671 and \$406,209 respectively were recorded by the Company for the three and nine months ended September 30, 2007. At September 30, 2008, total unrecognized stock-based compensation expense expected to be charged to operations over the next four years is estimated to approximate \$4,613,000.

The intrinsic values (aggregate market value of the underlying common stock minus aggregate exercise price) of stock options exercised during the three and nine months ended September 30, 2008 were \$473 and \$183,215, respectively. The total fair value of options vested during the three and nine months ended September 30, 2008 was approximately \$512,735 and \$687,488, respectively.

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Stock-based compensation expense related to stock options for the three and nine months ended September 30, 2008 and 2007 was allocated as follows:

|                            | Three Months Ended<br>September 30, |            | Nine Months Ended<br>September 30, |            |
|----------------------------|-------------------------------------|------------|------------------------------------|------------|
|                            | 2008                                | 2007       | 2008                               | 2007       |
| Research and development   | \$ 57,342                           | \$ 81,856  | \$ 164,452                         | \$ 115,912 |
| Sales and marketing        | \$ 58,473                           | \$ 38,336  | \$ 156,192                         | \$ 65,776  |
| General and administrative | \$ 205,085                          | \$ 157,389 | \$ 643,426                         | \$ 224,521 |
| Total                      | \$ 320,900                          | \$ 277,581 | \$ 964,070                         | \$ 406,209 |

**6. COMPREHENSIVE INCOME**

SFAS No. 130, *Reporting Comprehensive Income*, establishes standards for reporting and displaying comprehensive income and its components in financial statements. Comprehensive income is defined to include all changes in stockholders' equity during the period other than those changes that result from investments by and distributions to stockholders. For the three and nine months ended September 30, 2008 and 2007, the Company's comprehensive income is the sum of net income and the foreign currency translation adjustment, as follows:

|   | For the Three Months Ended<br>September 30, |              | For the Nine Months<br>Ended<br>September 30, |              |
|---|---|--------------|---|--------------|
|   | 2008  | 2007         | 2008  | 2007         |
| Net income                              | \$ 131,122                                  | \$ 2,778,384 | \$ 235,014                                    | \$ 4,703,081 |
| Other comprehensive income:             |   |              |   |              |
| Foreign currency translation adjustment | 296,504                                     | 155,031      | 1,518,085                                     | 354,860      |
| Total comprehensive income              | \$ 427,626                                  | \$ 2,933,415 | \$ 1,753,099                                  | \$ 5,057,941 |

**7. COMMON STOCK**

On November 9, 2007, the Company's board of directors approved a 1-for-2 reverse stock split of the Company's outstanding common stock. The reverse stock split became effective on November 20, 2007 and all common shares and per share amounts in the accompanying consolidated financial statements and notes to the consolidated financial statements have been retroactively adjusted for all periods presented to give effect to the reverse stock split.

In December 2007, the Company completed its initial public offering (IPO) of 6,000,000 shares of its common stock at a price to the public of \$10.00 per share. The Company raised a total of \$52.6 million in net proceeds after deducting underwriting discounts and offering expenses. Upon the closing of the offering, all shares of the Company's redeemable convertible preferred stock automatically converted into 14,060,818 shares of common stock. In January 2008, the underwriters of the Company's initial public offering exercised their over-allotment option to purchase 823,000 shares. The Company received net proceeds of \$7.6 million from this exercise, after deducting underwriting discounts and offering expenses.

The holders of the Company's common stock are entitled to one vote for each share held. At September 30, 2008, the outstanding shares of the Company's common stock are 23,790,100 shares. The Company has reserved 3,088,630 shares for the issuance of stock options outstanding and available to grant under its stock option plans.

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In June 2008, the Company issued 95,000 shares of its common stock to acquire an intangible asset consisting of knowhow related to a gas meter production process. The total acquisition value based on the market closing price of the Company's common stock at the acquisition date was \$509,200, which is expected to be amortized over 3 to 5 years.

**8. NET INCOME PER COMMON SHARE**

The following table provides the calculation of the basic and diluted income per share:

|  | Three Months Ended<br>September 30, |              | Nine Months Ended<br>September 30, |              |
|--|-------------------------------------|--------------|------------------------------------|--------------|
|  | 2008                                | 2007         | 2008                               | 2007         |
| <b>Numerator:</b>  |                                     |              |                                    |              |
| Net income   | \$ 131,122                          | \$ 2,778,384 | \$ 235,014                         | \$ 4,703,081 |
| Allocation of net income:                                    |                                     |              |                                    |              |
| <b>Basic:</b>  |                                     |              |                                    |              |
| Accretion of preferred stock                                 | \$                                  | \$ 422,240   | \$                                 | \$ 1,262,219 |
| Undistributed net income allocated to preferred stockholders |                                     | 2,003,299    |                                    | 2,935,353    |
| Net income available to preferred stockholders               |                                     | 2,425,539    |                                    | 4,197,572    |
| Net income available to common stockholders                  | \$ 131,122                          | \$ 352,845   | \$ 235,014                         | \$ 505,509   |
| Net income   | \$ 131,122                          | \$ 2,778,384 | \$ 235,014                         | \$ 4,703,081 |
| <b>Diluted:</b>  |                                     |              |                                    |              |
| Accretion of preferred stock                                 | \$                                  | \$ 422,240   | \$                                 | \$ 1,262,219 |
| Undistributed net income allocated to preferred stockholders |                                     | 1,929,501    |                                    | 2,862,650    |
| Net income available to preferred stockholders               |                                     | 2,351,741    |                                    | 4,124,869    |
| Net income available to common stockholders                  | 131,122                             | 426,643      | 235,014                            | 578,212      |
| Net income   | \$ 131,122                          | \$ 2,778,384 | \$ 235,014                         | \$ 4,703,081 |
| <b>Denominator:</b>  |                                     |              |                                    |              |
| Basic weighted average shares                                | 23,789,899                          | 2,476,562    | 23,654,292                         | 2,413,645    |
| Dilutive effect of common stock equivalents                  | 94,500                              | 632,505      | 228,993                            | 417,249      |
| Dilutive weighted average shares                             | 23,884,400                          | 3,109,066    | 23,883,286                         | 2,830,894    |
| <b>Calculation of Net Income Per Common Share:</b>           |                                     |              |                                    |              |
| <b>Basic</b>   |                                     |              |                                    |              |
| Net income available to common stockholders                  | \$ 131,122                          | \$ 352,845   | \$ 235,014                         | \$ 505,509   |
| Weighted average shares outstanding                          | 23,789,899                          | 2,476,562    | 23,654,292                         | 2,413,645    |
| Net income per common share                                  | \$ 0.01                             | \$ 0.14      | \$ 0.01                            | \$ 0.21      |
| <b>Diluted</b>   |                                     |              |                                    |              |
| Net income available to common stockholders                  | \$ 131,122                          | \$ 426,643   | \$ 235,014                         | \$ 578,212   |
| Weighted average shares outstanding                          | 23,884,400                          | 3,109,066    | 23,883,286                         | 2,830,894    |

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|                             |    |      |    |      |    |      |    |      |
|-----------------------------|----|------|----|------|----|------|----|------|
| Net income per common share | \$ | 0.01 | \$ | 0.14 | \$ | 0.01 | \$ | 0.20 |
|-----------------------------|----|------|----|------|----|------|----|------|

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The Company conducts its operations and manages its business in one segment, the development and design, manufacture and sale of semiconductor sensor systems solutions based on micro electromechanical systems (MEMS) technology and advanced integrated circuit design. Within this segment, the Company's chief executive officer views the operations of the manufacturing unit and the sales and marketing organizations as an integrated business unit and utilizes enterprise wide operating results as the only factor in making operating decisions.

Revenues by geographical region are as follows:

|                        | Three months ended<br>September 30, |              | Nine months ended<br>September 30, |               |
|------------------------|-------------------------------------|--------------|------------------------------------|---------------|
|                        | 2008                                | 2007         | 2008                               | 2007          |
| Asia (excluding Japan) | \$ 2,637,888                        | \$ 6,633,523 | \$ 6,957,428                       | \$ 11,780,217 |
| Europe                 | 378,672                             | 240,859      | 1,065,786                          | 742,747       |
| Japan                  | 850,686                             | 876,066      | 2,741,911                          | 2,484,983     |
| North America          | 1,148,176                           | 1,533,043    | 4,109,094                          | 3,669,300     |
| Other                  |                                     | 44,525       | 3,243                              | 91,343        |
| Total                  | \$ 5,015,422                        | \$ 9,328,016 | \$ 14,877,461                      | \$ 18,768,590 |

Revenues by product application are as follows:

|                  | Three months ended<br>September 30, |              | Nine months ended<br>September 30, |               |
|------------------|-------------------------------------|--------------|------------------------------------|---------------|
|                  | 2008                                | 2007         | 2008                               | 2007          |
| Mobile phone     | \$ 2,045,714                        | \$ 6,114,515 | \$ 5,069,739                       | \$ 10,361,526 |
| Consumer         | 1,225,735                           | 1,111,519    | 4,504,623                          | 3,310,441     |
| Automotive       | 1,294,009                           | 1,441,383    | 4,074,560                          | 3,693,156     |
| Industrial/other | 449,964                             | 660,599      | 1,228,538                          | 1,403,467     |
| Total            | \$ 5,015,422                        | \$ 9,328,016 | \$ 14,877,460                      | \$ 18,768,590 |

Total assets by geographical region are as follows:

|               | September 30,<br>2008 | December 31,<br>2007 |
|---------------|-----------------------|----------------------|
| United States | \$ 60,048,665         | \$ 71,469,309        |
| China         | 36,665,256            | 17,382,255           |
| Total         | \$ 96,713,921         | \$ 88,851,564        |

**10. SUBSEQUENT EVENT**

On October 15, 2008, the Company entered into a Convertible Note Agreement with Intelligent Spatial Technologies, Inc. ( iST ), where the Company provided a loan in the amount of \$300,000 to iST at an interest rate of 6% per annum for developing application technology synergistic to the Company's emerging product solutions. The principal amount, together with any then unpaid accrued interest and all other amounts owed (the Outstanding Balance ) shall be due and payable on July 31, 2011. This loan has a conversion feature. In the event of iST's financing or acquisition prior to the repayment of the Outstanding Balance, the Outstanding Balance shall automatically be converted into iST's capital stock or equity securities at a conversion price equal to 50% of the per share selling price sold in iST's financing or acquisition.



**Table of Contents****Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.**

*This quarterly report on Form 10-Q contains forward-looking statements that involve risks and uncertainties, as well as assumptions that, if they never materialize or prove incorrect, could cause our results to differ materially from those expressed or implied by such forward-looking statements. The statements contained in this Quarterly Report on Form 10-Q that are not purely historical are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Such forward-looking statements include any expectation of earnings, revenues, billings or other financial items; any statements of the plans, strategies and objectives of management for future operations; factors that may affect our operating results; statements concerning new products or services; statements related to future capital expenditures; statements related to future economic conditions or performance; statements as to industry trends and other matters that do not relate strictly to historical facts or statements of assumptions underlying any of the foregoing. These statements are often identified by the use of words such as, but not limited to, anticipate, believe, continue, could, estimate, expect, intend, may, will, plan, target, continue, and similar expressions or variations intended to identify forward-looking statements. These statements are based on the beliefs and assumptions of our management based on information currently available to management. Such forward-looking statements are subject to risks, uncertainties and other important factors that could cause actual results and the timing of certain events to differ materially from future results expressed or implied by such forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those identified below, and those discussed in the section titled Risk Factors included elsewhere in this Form 10-Q and in our other filings with the SEC. Furthermore, such forward-looking statements speak only as of the date of this report. We undertake no obligation to update any forward-looking statements to reflect events or circumstances after the date of such statements.*

**OVERVIEW**

We provide advanced semiconductor sensor and system solutions based on integrated MEMS technology and mixed signal circuit design. Our accelerometer products are used to measure tilt, shock, vibration and acceleration, and have a wide range of applications such as mobile phones, automotive safety systems and video projectors. We combine proprietary thermal-based MEMS technology and advanced analog mixed signal processing circuitry design into a single chip using a standard CMOS process. In many instances, this approach allows us to provide sensor solutions at a lower cost, with higher performance and greater functionality than our competitors. In addition, our technology platform allows us to easily integrate additional functions or create new sensors to expand into magnetic, touch and flow sensors and related applications.

We have experienced significant growth since our products were first commercialized in 2001. We shipped more than 41 million units of accelerometers from 2004 through September 30, 2008. In 2007, 2006, and 2005, our net sales totaled \$25.3 million, \$13.1 million and \$9.1 million, respectively. The increases in our unit sales volume and sales revenue have primarily been attributable to increases in the sale of our products for mobile phone applications and automotive applications. More recently, however, our net sales have been adversely affected on a number of factors including a slowdown in the China mobile handset market and the recent earthquake in China, as well as global economic conditions. Our net sales for the nine months ended September 30, 2008 were \$14.9 million. We expect sales of our accelerometer products to continue to represent a predominant share of our revenue for the foreseeable future. We expect to begin commercial sales of our first non-accelerometer products, including magnetic sensors, in 2008.

We sell our products either to distributors, which then resell to OEMs and ODMs, or to OEM and ODM customers directly. Historically, a small number of our customers have accounted for a substantial portion of our revenue, and sales to our largest distributor customers and OEM and ODM customers have varied significantly. This significant variation is in part due to the fact that our sales are made on the basis of purchase orders rather than long-term contracts. Although our distributors generally provide us with non-binding rolling forecasts, our distributors generally have up to 30 days prior to delivery to cancel or reschedule shipments pursuant to our distribution agreements. This arrangement has added to the fluctuation and unpredictability of our sales. Because our products are a component of our customers' products, our sales performance is significantly affected by the sales performance of our customers' products. It is difficult for us to accurately forecast our product demand because in the case where we sell our products to distributors, we may not know the identity of the distributor's OEM and ODM customers and information regarding their demand.



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OEM and ODM customers' products are complex and require significant time to define, design and ramp to volume production. Our sales cycle begins with our marketing and sales staff and application engineers engaging with our OEM and ODM customers' system designers and management, which is typically a multi-month, or even multi-year, process. If such process is successful, an OEM and ODM customer will decide to incorporate our solution in its product, which we refer to as a design-win. Because the sales cycles for our products are long, we incur expenses to develop and sell our products, regardless of whether we achieve the design-win and well in advance of generating revenue, if any, from those expenditures. Although we do not have long-term purchase commitments from any of our distributor customers or OEM and ODM customers, once one of our products is incorporated into an OEM's or ODM's design, it is likely to remain a part of the design for the life cycle of its product. We believe this to be the case because a redesign would generally be time consuming and expensive. We have experienced revenue growth due to an increase in the number of our products offered, an expansion of our customer base, an increase in the number of design-wins within any one OEM and ODM customer and an increase in the average revenue per design-win.

We manufacture our products utilizing a semi-fabless model by outsourcing the production of CMOS wafers and completing the post-CMOS MEMS process in-house. By outsourcing the standard CMOS manufacturing process, we are able to more efficiently manage our capital expenditures and cost of goods sold.

### **Description of Certain Line Items**

#### *Net Sales*

Net sales represent gross revenue net of an allowance for the estimated amount of product returns and sales rebates from our customers. Sales to distributors are made pursuant to distributor agreements, which allow for the return of goods under certain circumstances. We recognize revenue in accordance with Staff Accounting Bulletin No. 104 and Statement of Financial Accounting Standards No. 48, or SFAS 48. While we sell our products to distributors as well as end customers, sales to distributors account for a significant amount of the total revenue. Prior to August 30, 2007, we deferred recognition of sales to a major distributor, World Peace Industrial Co., Ltd., or WPI, which did not meet the criteria of SFAS 48, until the product was sold through to WPI's OEM and ODM customers. WPI accounted for 55.3 % of our revenue in 2007 and 34.6% of our revenue in 2006. On August 30, 2007, we amended the distributor agreement with WPI to allow returns only upon our approval. Accordingly, the criteria under SFAS 48 have been met for this distributor as of August 30, 2007, and we have recognized revenue upon shipment to WPI for all shipments subsequent to this date. For all shipments to WPI made prior to August 30, 2007, we continued to recognize our revenue upon shipments to its OEM and ODM customers.

Historically, our revenue has been derived primarily from shipments of our accelerometer products. The primary factors that affect our revenue are the sales volumes and average selling prices of our products. The significant increases in our net sales have been primarily attributable to the increases in the unit volumes of our products, particularly those for mobile phone and automotive applications. The average selling prices of our products generally decline over time and are primarily affected by a combination of the following factors:

the semiconductor market is highly competitive, and as a result, the average selling prices of particular products generally experience rapid declines over the course of their respective product and technology life cycles. This trend has been particularly evident recently in the market for mobile phone applications. We seek to mitigate the impact of this trend on our business by continuing to rapidly design, develop and sell new generations of products with additional functionalities to replace older generation products;

we may also reduce our product prices as we are able to increase our production yields or to reduce our manufacturing costs, particularly the wafer prices;

changes in our product mix may affect the average selling prices of our products. Historically, for example, our revenue derived from consumer and mobile phone markets, as a percentage of our total revenue, has increased. Our products for these markets generally have lower average selling prices than products for the automotive market. The average selling prices of products may continue to be affected by our strategy to increase market adoption of our products in certain markets; and

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we occasionally grant discounts or modified payment terms to our large customers or OEM and ODM customers for high volume purchases.

During the second quarter of 2008, we reversed \$2.0 million in revenue from the sale of printed circuit boards that were shipped and sold in the first quarter of 2008 for use in the Olympic torch project. Problems experienced by our customer, due in part to the recent earthquake in China, prevented the timely commercial introduction of the Olympic torch, and the customer invoked a clause in its contract with us that permitted the customer to suspend the project in the event of a natural disaster such as an earthquake. As a result, we reversed the previously recognized revenue and the related account receivable in the second quarter.

**Net Sales by Application**

Net sales from mobile phone applications, as a percentage of total net sales, have increased in recent years, but we expect sales in this market to stay flat or slightly decrease for the remainder of 2008 due to the slowdown of the China mobile phone market. We are taking initiatives to diversify our revenue sources and reduce our exposure to cyclicity in the cellular handset market. Net sales from automotive applications, in absolute terms, have increased, primarily attributable to increases in sales of rollover application products to Autoliv Inc., although this trend did not continue in the third quarter of 2008. To increase net sales from the automotive market, we are currently seeking to increase sales from other automotive applications and to expand our customer base. However, revenue increases, if any, from the automotive market will require significant time, as the development lead time in this market is generally longer than other markets. Net sales from consumer applications have fluctuated historically as a result of the generally short life cycle of consumer electronics and changes in our customer base. As our product offering and customer base for consumer applications continue to diversify, we expect the net sales from consumer applications to fluctuate less. Revenue from industrial and medical markets historically have been limited, and while we do not expect revenue from these markets to contribute significantly to our total revenue in the near term, we expect revenue from these markets to increase in the longer term, as we increase our penetration of these markets and introduce new products designed for industrial applications.

The following table sets forth our net sales by application for the periods indicated by amount and as a percentage of our net sales (dollar amounts in thousands).

|                  | Three months ended September 30, |               |                 |               | Nine months ended September 30, |               |                  |               |
|------------------|----------------------------------|---------------|-----------------|---------------|---------------------------------|---------------|------------------|---------------|
|                  | 2008                             |               | 2007            |               | 2008                            |               | 2007             |               |
|                  | Amount                           | % of Sales    | Amount          | % of Sales    | Amount                          | % of Sales    | Amount           | % of Sales    |
| Mobile phone     | \$ 2,045                         | 40.8%         | \$ 6,115        | 65.6%         | \$ 5,070                        | 34.1%         | \$ 10,362        | 55.2%         |
| Consumer         | 1,226                            | 24.4          | 1,111           | 11.8          | 4,505                           | 30.3          | 3,310            | 17.6          |
| Automotive       | 1,294                            | 25.8          | 1,441           | 15.5          | 4,074                           | 27.4          | 3,693            | 19.7          |
| Industrial/other | 450                              | 9.0           | 661             | 7.1           | 1,228                           | 8.2           | 1,404            | 7.5           |
| <b>Total</b>     | <b>\$ 5,015</b>                  | <b>100.0%</b> | <b>\$ 9,328</b> | <b>100.0%</b> | <b>\$ 14,877</b>                | <b>100.0%</b> | <b>\$ 18,769</b> | <b>100.0%</b> |

**Net Sales by Customer Base**

Our customers primarily consist of distributors, OEMs and ODMs. Historically, a small number of our customers have accounted for a substantial portion of our net sales. We expect that significant customer concentration will continue for the foreseeable future. Our customers representing 10% or more of our net sales accounted for approximately 71.6%, 65.6% and 60.3%, respectively, of our net sales in 2007, 2006 and 2005.

We have experienced and will continue to experience fluctuations in demand from a significant number of customers, including many of our largest customers. It is difficult for us to accurately forecast our product demand, particularly in the case of sales to our distributors, as we may not know the identity of the distributor's OEM and ODM customers and lack information regarding their demand, and recent adverse macro-economic changes have increased the difficulty of accurately forecasting product demand and revenue.

Occasionally, design changes in the products of our OEM and ODM customers have resulted in the loss of sales. For example, a design change in a product of a large OEM customer in 2005 for consumer applications resulted in the loss of our sales to such customer in 2006. That customer accounted for 30.0% of our net sales in 2005.



**Table of Contents****Net Sales by Geography**

Our products are shipped to OEM and ODM customers worldwide. However, we focus on different application markets within geographical regions. In the greater China region, our revenue has historically been primarily derived from products for mobile phone applications. We are also seeking to expand the consumer application market in the greater China region. In Japan, our revenue has primarily been derived from products for consumer applications, particularly projectors. We are also seeking to penetrate the automotive market in Japan. In North America, our revenue has primarily been derived from products for automotive applications. In Europe, our revenue has fluctuated as a result of the gain and subsequent loss of a significant customer for global positioning system, or GPS, applications. We also derive significant revenue from products for automotive applications in Europe.

The following table sets forth our net sales by geographical region for the periods indicated by amount and as a percentage of our net sales (dollar amounts in thousands).

|                        | Three months ended September 30, |            |          |            | Nine months ended September 30, |            |           |            |
|------------------------|----------------------------------|------------|----------|------------|---------------------------------|------------|-----------|------------|
|                        | 2008                             |            | 2007     |            | 2008                            |            | 2007      |            |
|                        | Amount                           | % of Sales | Amount   | % of Sales | Amount                          | % of Sales | Amount    | % of Sales |
| Asia (excluding Japan) | \$ 2,638                         | 52.6%      | \$ 6,634 | 71.1%      | \$ 6,957                        | 46.8%      | \$ 11,781 | 62.8%      |
| Europe                 | 379                              | 7.5        | 241      | 2.6        | 1,066                           | 7.2        | 743       | 4.0        |
| Japan                  | 851                              | 17.0       | 876      | 9.4        | 2,742                           | 18.4       | 2,485     | 13.2       |
| North America          | 1,147                            | 22.9       | 1,533    | 16.4       | 4,109                           | 27.6       | 3,669     | 19.5       |
| Other                  |                                  |            | 44       | 0.5        | 3                               |            | 91        | 0.5        |
| Total                  | \$ 5,015                         | 100%       | \$ 9,328 | 100.0%     | \$ 14,877                       | 100%       | \$ 18,769 | 100%       |

**Cost of Goods Sold**

We are a semi-fabless company. We outsource wafer production to third-party foundries and complete the post-CMOS MEMS and most of the packaging, assembly and testing functions in-house. We also purchase our ceramic packaging materials from third-party suppliers. Cost of goods sold consists of: (i) cost of wafer, ceramic and other materials purchased from third parties; (ii) manufacturing overhead, primarily consisting of salaries and wages of our quality control employees and manufacturing-related management employees, depreciation, and equipment and parts; (iii) direct labor, primarily consisting of salaries and wages of our manufacturing operators; and (iv) outsourced processing fees paid to our third-party packaging service providers.

Our relationships with third-party foundry and packaging service providers do not provide for guaranteed levels of production capacity at pre-determined prices. As a result, our outsourcing costs relating to wafer production, and to a lesser extent, packaging services, are susceptible to changes based on conditions in the global semiconductor market and our service providers' available capacity.

Prior to August 30, 2007 we deferred recognition of cost of goods sold for a major distributor, WPI, which did not meet the criteria of SFAS 48, until the product was sold through to WPI's OEM and ODM customers. WPI accounted for 34.6% of our revenue in 2006 and 55.3% of our revenue in 2007. On August 30, 2007, we amended the distributor agreement with WPI to allow for returns only upon our approval. Accordingly, the criteria under SFAS No. 48 have been met for this distributor as of August 30, 2007, and subsequent to that date we have recognized the cost of goods sold as the related products are sold. For all shipments to WPI made prior to August 30, 2007, we continued to recognize costs related to products once sold by WPI to its OEM and ODM customers.

**Gross Profit and Gross Margin**

Historically, our gross profit has generally experienced growth in line with increases in our revenue, and until recently our gross margin has remained relatively stable, at 65.1%, 67.0%, and 68.1%, respectively, in 2007, 2006 and 2005. However, our gross profit and gross margin may fluctuate significantly in the future as a result of a variety of factors, including average selling prices of our products, our product application mix, prices of wafers, excess and obsolete inventory, pricing by competitors, changes in production yields, and percentage of sales conducted through distributors. Our products for mobile phone applications, which are sold to distributor customers, have historically had lower margins than our products for automotive products, which are sold directly to our OEM and ODM customers, and these margins have continued to decline due to competitive price pressure in this market.



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The increase in the percentage of our net sales in products for mobile phone applications in recent years has therefore had an adverse effect on our overall gross margin. The slowdown of the China mobile phone market in 2008 has caused severe pricing competition, which has also caused our gross margin to decline. Our gross margin for the three and nine months ended September 30, 2008 was 51.3% and 48.7%, respectively.

### ***Research and Development Expenses***

Research and development expenses are recognized as they are incurred and primarily consist of salaries and wages of research and development employees; research costs, primarily consisting of mask costs and prototype wafers, consulting fees paid for outside design services; travel and other expenses; and stock-based compensation under SFAS 123(R) attributable to our research and development employees.

Historically, research and development expenses have increased both in absolute terms and as a percentage of total net sales. We expect this trend to continue for the foreseeable future as we seek to diversify into non-accelerometer products and hire additional employees in connection with the new research and development institute that we established in the second quarter of 2007.

### ***Sales and Marketing Expenses***

Sales and marketing expenses primarily consist of wages, salaries and commissions for our sales and marketing personnel; consulting expenses, primarily consisting of sales consulting services and software application consulting services; travel expenses; independent sales representatives commissions; office rental; market promotion and other expenses; and stock-based compensation under SFAS 123(R). We expect sales and marketing expenses to continue to increase as we hire additional sales and marketing personnel, expand our sales and marketing network and engage in additional marketing and promotional activities.

### ***General and Administrative Expenses***

General and administrative expenses primarily consist of salaries and wages for administrative personnel; costs for professional services, including legal, tax and accounting services; depreciation and amortization expenses for non-manufacturing equipment; travel expenses; office supply and other office-related expenses; office rental expenses; other expenses, such as utilities, insurance and provision for accounts receivable; and stock-based compensation under SFAS 123(R). We expect that our general and administrative expenses will increase as we hire additional personnel and incur costs related to the anticipated growth of our business and our operations as a public company.

### ***Other Income (Expense)***

Other income (expense), primarily consists of interest income earned on our investments of cash and cash equivalents, and interest expense incurred on our borrowings and net foreign currency exchange gains and losses.

### ***Provision (Benefit) for Income Taxes***

We conduct sales through our headquarters in Andover, Massachusetts. Our Wuxi subsidiary, MEMSIC Semiconductor, is primarily engaged in manufacturing and engineering activities and generally does not conduct direct sales to customers. For internal accounting and PRC tax purposes, we account for the transfers of goods from our Wuxi subsidiary, MEMSIC Semiconductor, to our U.S. headquarters as sales, and calculate the transfer price of such sales based on a markup of manufacturing and operating costs. We believe the prices of these sales were consistent with the prevailing market prices.

### ***U.S. Tax***

In the United States, we are subject to the federal income tax and the Massachusetts state income tax, which are approximately at the rates of 34% and 9.5%, respectively. We utilized federal net operating losses ( NOLs ) of \$1.9 million and state NOLs of \$1.7 million in 2007. As of December 31, 2007, we had NOLs of approximately \$15,000, which will expire in 2023, and no state NOL carryforwards. We may be subject to Section 382 of the United States Internal Revenue Code which imposes certain limitations on net operating losses that we could utilize in the event of an ownership change of our company. However, we do not believe the impact of any such limitations would have a material impact on our ability to utilize our remaining federal NOL carryforward.



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Our policy is to reinvest any earnings of MEMSIC Semiconductor in our Chinese operations. We have not provided for the U.S. income taxes that could result from the distribution of such earnings to the U.S. parent. If these earnings were ultimately distributed to the U.S. in the form of dividends or otherwise, or if the shares of MEMSIC Semiconductor were sold or transferred, we would be subject to additional U.S. income taxes on these undistributed earnings.

*PRC Tax*

Our PRC taxes primarily consist of enterprise income tax, value-added tax, and certain other miscellaneous taxes. As of December 31, 2007, our Wuxi subsidiary, MEMSIC Semiconductor, had no PRC NOL carryforwards available to offset future PRC enterprise income tax and entered into the first year of the two year tax exemption period.

*Enterprise Income Tax*

PRC enterprise income tax is calculated based on taxable income determined under PRC accounting principles. Prior to January 1, 2008, according to the applicable PRC tax laws, foreign investment enterprises, or FIEs, incorporated in the PRC were generally subject to an enterprise income tax rate of 33%. A high-technology FIE registered and operating in a designated high-technology zone would be entitled to a preferential enterprise income tax rate of 15%, whereas a manufacturing FIE that was scheduled to operate for no less than 10 years was eligible for an exemption from state income taxes for two years starting from its first profit-making year, followed by a 50% reduction in the succeeding three years. The qualification of a high-technology FIE was subject to a biennial evaluation by the relevant government authority in China.

Our Wuxi subsidiary, MEMSIC Semiconductor, as a high-technology FIE registered and operating in a designated high-technology zone and a manufacturing FIE that is scheduled to operate for no less than 10 years, was entitled to a preferential enterprise income tax rate of 15% as well as a five-year tax holiday, pursuant to which it was exempted from paying the enterprise income tax for 2007, the year in which it first had positive accumulated earnings, and 2008, followed by a 50% reduction from 2009 to 2011.

On March 16, 2007, the National People's Congress approved and promulgated a new tax law named Enterprise Income Tax Law, which took effect beginning January 1, 2008. Under the new tax law, FIEs and domestic companies are subject to a uniform tax rate of 25%. The new tax law provides a five-year transition period starting from its effective date for those enterprises which were established before the promulgation date of the new tax law and which were entitled to a preferential lower tax rate under the then effective tax laws or regulations. In accordance with regulations issued by the State Council, the tax rate of such enterprises may gradually transition to the uniform tax rate within the transition period. For those enterprises which are enjoying tax holidays, such tax holidays may continue until their expiration in accordance with the regulations issued by the State Council, but where the tax holiday has not yet started because of losses, such tax holiday shall be deemed to commence from the first effective year of the new tax law. While the new tax law equalizes the tax rates for FIEs and domestic companies, preferential tax treatment would continue to be given to companies in certain encouraged sectors and to entities classified as high-technology companies especially supported by the PRC government, whether FIEs or domestic companies. As a result of the new tax law, following the year 2011, upon expiration of our 50% reduction from the then applicable income tax rate, our effective tax rate may increase, unless we are otherwise eligible for preferential treatment.

The new tax law and its implementing rules provide that dividends paid by a PRC entity to a non-resident enterprise for tax purposes is subject to PRC withholding tax at a rate of 10% subject to reduction by an applicable tax treaty with the PRC. We expect that a 10% withholding tax will apply to dividends paid to us by our Wuxi subsidiary, but this treatment will depend on our status as a non-resident enterprise of China. For detailed discussion of PRC tax issues related to resident enterprise status, see Risk Factors - Risks Related to Doing Business in China - We may be treated as a resident enterprise for PRC tax purposes under the Enterprise Income Tax Law effective as of January 1, 2008, which may subject us to PRC income tax for any dividends we pay to our non-PRC stockholders in our Annual Report on Form 10-K for the year ended December 31, 2007. Based on the existing local tax regulations, our Wuxi subsidiary, which is in the 2-year tax holiday will not be allowed to distribute any dividends until it starts to pay the income taxes to the local tax authorities. In addition, MEMSIC Semiconductor has reinvested 100% of its net income in manufacturing expansion and new product development and has no plan to distribute dividends to its parent company.



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*Other PRC Taxes*

Other miscellaneous PRC taxes primarily consist of property tax, land-use tax and stamp tax which are accounted for in our general and administrative expenses, and education surcharge, which is recorded as part of our cost of goods sold.

**Critical Accounting Policies and Estimates**

The preparation of our consolidated financial statements and related notes requires us to make judgments, estimates and assumptions that affect the reported amounts of assets, liabilities, net sales and expenses, and related disclosure of contingent assets and liabilities. We have based our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

An accounting policy is considered to be critical if it requires an accounting estimate to be made based on assumptions about matters that are highly uncertain at the time the estimate is made, and if different estimates that reasonably could have been used, or changes in the accounting estimates that are reasonably likely to occur periodically, could materially impact the consolidated financial statements. For a discussion of the critical accounting policies that we consider to be the most sensitive and that require the most significant estimates and assumptions used in the preparation of our consolidated financial statements, see our Annual Report on Form 10-K for the year ended December 31, 2007, and our Quarterly Report on Form 10-Q for the three months ended June 30, 2008, under the heading Management's Discussion and Analysis of Financial Condition and Results of Operations Critical Accounting Policies.

**Table of Contents****RESULTS OF OPERATIONS**

The following tables set forth a summary of our unaudited consolidated statements of operations data for the periods described by amount and as a percentage of our total net sales. This information should be read together with our unaudited consolidated financial statements and related notes included elsewhere in this Quarterly Report on Form 10-Q. The operating results in any period are not necessarily indicative of the results that may be expected for any future period:

|  | Three months ended September 30, |                |          |                | Nine months ended September 30, |                |           |                |
|--|----------------------------------|----------------|----------|----------------|---------------------------------|----------------|-----------|----------------|
|  | 2008                             |                | 2007     |                | 2008                            |                | 2007      |                |
|  | Amount                           | % of net sales | Amount   | % of net sales | Amount                          | % of net sales | Amount    | % of net sales |
|  | (dollar amounts in thousands)    |                |          |                | (dollar amounts in thousands)   |                |           |                |
| Net sales                                    | \$ 5,015                         | 100.0%         | \$ 9,328 | 100.0%         | \$ 14,877                       | 100.0%         | \$ 18,769 | 100.0%         |
| Cost of goods sold                           | 2,443                            | 48.7%          | 3,280    | 35.2%          | 7,638                           | 51.3%          | 6,449     | 34.4%          |
| Gross profit                                 | 2,572                            | 51.3%          | 6,048    | 64.8%          | 7,239                           | 48.7%          | 12,320    | 65.6%          |
| Operating expenses:                          |                                  |                |          |                |                                 |                |           |                |
| Research and development                     | 861                              | 17.2%          | 969      | 10.4%          | 2,619                           | 17.6%          | 2,411     | 12.8%          |
| Sales and marketing                          | 772                              | 15.4%          | 843      | 9.0%           | 2,201                           | 14.8%          | 2,100     | 11.2%          |
| General and administrative                   | 1,705                            | 33.9%          | 1,094    | 11.7%          | 4,467                           | 30.0%          | 2,641     | 14.1%          |
| Total operating expenses                     | 3,338                            | 66.5%          | 2,907    | 31.2%          | 9,287                           | 62.4%          | 7,152     | 38.1%          |
| Operating income (loss)                      | (766)                            | (15.2)%        | 3,141    | 33.7%          | (2,048)                         | (13.7)%        | 5,168     | 27.5%          |
| Other income (expense):                      |                                  |                |          |                |                                 |                |           |                |
| Interest and dividend income                 | 514                              | 10.3%          | 173      | 1.9%           | 1,735                           | 11.7%          | 484       | 2.6%           |
| Interest expense                             | (0)                              | 0.0%           | (23)     | -0.2%          | (24)                            | -0.2%          | (23)      | -0.1%          |
| Other, net                                   | 218                              | 4.4%           | 15       | 0.2%           | 382                             | 2.6%           | 32        | 0.2%           |
| Total other income (expense)                 | 732                              | 14.7%          | 165      | 1.8%           | 2,093                           | 14.1%          | 493       | 2.6%           |
| Earnings (loss) before income taxes          | (34)                             | (0.6)%         | 3,306    | 35.4%          | 45                              | 0.4%           | 5,661     | 30.1%          |
| Provision (benefit) for income taxes         | (165)                            | (3.3)%         | 528      | 5.7%           | (190)                           | (1.3)%         | 958       | 5.1%           |
| Net income                                   | \$ 131                           | 2.7%           | \$ 2,778 | 29.8%          | \$ 235                          | 1.7%           | \$ 4,703  | 25.0%          |
| Net income available to common stockholders: |                                  |                |          |                |                                 |                |           |                |
| Basic  | \$ 131                           | 2.7%           | \$ 353   | 3.8%           | \$ 235                          | 1.7%           | \$ 506    | 2.7%           |
| Diluted                                      | \$ 131                           | 2.7%           | \$ 427   | 4.6%           | \$ 235                          | 1.7%           | \$ 578    | 3.1%           |

**Quarter Ended September 30, 2008 Compared to Quarter Ended September 30, 2007**

**Net sales.** Our net sales decreased by 46.2% to \$5.0 million for the three months ended September 30, 2008 from \$9.3 million in the corresponding period of 2007. This decrease was due primarily to the decrease in mobile phone sales. Sales in mobile phone applications accounted for \$2.0 million in net sales in the three months ended September 30, 2008, compared to \$6.1 million in the corresponding period for 2007. The decrease in sales to mobile phone applications reflected reduced demand for products in the mobile handset market in China and increased pricing pressure. Sales in automotive applications experienced a slight decrease, accounting for \$1.3 million for the three months ended September 30, 2008, compared to \$1.4 million in the corresponding period in 2007. Sales to Autoliv, a significant customer, amounted to \$1.0 million, or 19.8% of our net sales for the third quarter of 2008, compared to \$1.5 million, or 16.8% of our net sales in the corresponding period of 2007.

**Cost of goods sold.** Our cost of goods sold decreased by 25.5% to \$2.4 million for the three months ended September 30, 2008 from \$3.3 million for the corresponding period in 2007. This decrease was due to the decrease in the volume of units sold.

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**Gross profit and gross margin.** Our gross profit decreased by 57.5% to \$2.6 million for the three months ended September 30, 2008 from \$6.0 million in the corresponding period of 2007. Our gross margin decreased to 51.3% for the three months ended September 30, 2008 from 64.8% in 2007. This decrease was attributable to a continued decline in the average selling prices of our products in the mobile phone market as well as an increase in the manufacturing overhead cost per unit as a result of the reduced production volume.

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**Research and development.** Our research and development decreased by 11.1% to \$0.9 million for the three months ended September 30, 2008 from \$1.0 million in the corresponding period of 2007. This decrease was primarily due to less consulting cost in this period as compared to the corresponding period of 2007. Research and development expenses, as a percentage of total net sales, increased to 17.2% for the three months ended September 30, 2008 from 10.4% for the corresponding period of 2007. This increase was due to the decline in revenue.

**Sales and marketing.** Our sales and marketing expenses decreased by 8.4% to \$772,000 for the three months ended September 30, 2008 from \$843,000 for the corresponding period of 2007. The decrease was primarily due to lower commission and bonus expenses as a result of reduced revenue. Sales and marketing expenses, as a percentage of total net sales, increased to 15.4% for the three months ended September 30, 2008 from 9.0% for the corresponding period of 2007. This increase was due to the decline in revenue.

**General and administrative.** Our general and administrative expenses increased by 55.9% to \$1.7 million for the three months ended September 30, 2008 from \$1.1 million in the corresponding period of 2007. This increase was primarily due to (i) an increase of \$0.2 million in wages and salaries as a result of an increase in the number of administrative employees in response to the overall anticipated expansion of our business, (ii) an increase of \$0.3 million in professional fees as a result of our becoming a public company and (iii) an increase of \$0.1 million in stock-based compensation expense. General and administrative expenses, as a percentage of total net sales, increased to 33.9% for the three months ended September 30, 2008 from 11.7% for the corresponding period in 2007.

**Other income.** Our other income was \$0.7 million for the three months ended September 30, 2008 compared to \$0.2 million in the corresponding period of 2007. The increase was primarily due to an increase in interest and dividend income from IPO proceeds.

**Provision (benefit) for income taxes.** Our income tax benefit was \$165,000 for the three months ended September 30, 2008 compared to an income tax provision of \$528,000 in the corresponding period of 2007. Our tax benefit for the third quarter of 2008 reflected principally a tax benefit of \$99,000 due to losses generated in the U.S. and a deferred tax benefit of \$66,000 recorded by our Wuxi subsidiary. Our Wuxi subsidiary, which generated a substantial amount of our pretax income, currently was not taxed in China due to its tax holiday. Our Wuxi subsidiary's tax holiday is expected to end in 2009.

**Nine Months Ended September 30, 2008 Compared to Nine Months Ended September 30, 2007**

**Net Sales.** Our net sales decreased by 20.7% to \$14.9 million for the nine months ended September 30, 2008 from \$18.8 million in the corresponding period of 2007. The majority of the decrease was from our decline in mobile phone application sales. Sales in mobile phone applications accounted for \$5.1 million in net sales in for the nine months ended September 30, 2008, compared to \$10.4 million in the corresponding period for 2007. Sales in consumer applications increased to \$4.5 million for the nine months ended September 30, 2008, compared to \$3.3 million in the corresponding period of 2007. Sales in automotive applications accounted for \$4.1 million for the nine months ended September 30, 2008, compared to \$3.7 million in the corresponding period in 2007. Sales to Autoliv, a significant customer, amounted to \$3.2 million, or 21.3% of our net sales for the first nine months of 2008, compared to \$3.2 million, or 16.8% of our net sales in the corresponding period of 2007.

**Cost of goods sold.** Our cost of goods sold increased by 18.4% to \$7.6 million for the nine months ended September 30, 2008 from \$6.4 million for the corresponding period in 2007. The increase was primarily due to the cost related to the Olympic torch project and the increase of fixed manufacturing per unit cost as a result of lower production volume in the first nine months of 2008 compared to the corresponding period of 2007.

**Gross profit and gross margin.** Our gross profit decreased by 41.2% to \$7.2 million for the nine months ended September 30, 2008 from \$12.3 million in the corresponding period of 2007. Our gross margin decreased to 48.7% for the nine months ended September 30, 2008 from 65.6% in 2007 primarily due to continued decline in the average selling prices of our products in the mobile phone market as well as an increase in the manufacturing overhead cost per unit as a result of the reduced production volume.

**Research and development.** Our research and development expenses increased by 8.6% to \$2.6 million for the nine months ended September 30, 2008 from \$2.4 million in the corresponding period of 2007. This increase was primarily due to an increase in wages and salaries as a result of an increase in our head count for engineers and other research and development employees in both China and the U.S. Research and development expenses, as a percentage of total net sales, increased to 17.6% for the nine months ended September 30, 2008 from 12.8% for the corresponding period of 2007.

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**Sales and marketing.** Our sales and marketing expenses increased by 4.8% to \$2.2 million for the nine months ended September 30, 2008 from \$2.1 million for the corresponding period of 2007. The increase was primarily due to an increase in wages and salaries due to an increase in the number of sales and marketing employees. Sales and marketing expenses, as a percentage of total net sales, increased to 14.8% for the nine months ended September 30, 2008 from 11.2% for the corresponding period of 2007.

**General and administrative.** Our general and administrative expenses increased by 69.1% to \$4.5 for the nine months ended September 30, 2008 from \$2.6 million in the corresponding period of 2007. This increase was primarily due to (i) an increase of \$0.3 million in wages and salaries as a result of an increase in the number of administrative employees in response to the overall expansion of our business, (ii) an increase of \$0.5 million in professional fees as a result of our becoming a public company, (iii) an increase of \$0.8 million in stock-based compensation expense, (iv) an increase of \$0.2 million in D&O insurance and (v) an increase of \$0.1 million in depreciation and amortization expenses. General and administrative expenses, as a percentage of total net sales, increased to 30.0% for the nine months ended September 30, 2008 from 14.1% for the corresponding period in 2007.

**Other income.** Our other income was \$2.1 million for the nine months ended September 30, 2008 compared to \$0.5 million in the corresponding period of 2007. The increase was primarily due to an increase of \$1.3 million in interest and dividend income from IPO proceeds and a collection of \$0.1 million as a result of a contract settlement which was written in 2005.

**Provision (benefit) for income taxes.** Our income tax benefit was \$190,000 for the nine months ended September 30, 2008 compared to an income tax provision of \$958,000 in the corresponding period of 2007. Our tax benefit for the nine months ended September 30, 2008 reflected a tax benefit of \$99,000 due to a loss generated in the U.S. and the recognition of certain deferred tax assets in China. Our Wuxi subsidiary, which generated a substantial amount of our pretax income, currently is not taxed in China due to its tax holiday.

**LIQUIDITY AND CAPITAL RESOURCES**

Until our recent initial public offering, proceeds from private sales of our equity interests to investors have been critical to funding our operations and meeting our capital expenditure requirements. As a result of our initial public offering in December 2007 and the exercise by the underwriters of their over-allotment option in January 2008, we received net offering proceeds, after deducting underwriting discounts and offering expenses, of approximately \$60.2 million.

We have invested our net proceeds from the offering in money market funds and auction rate securities. As of September 30, 2008, our investments included \$5.8 million of auction rate securities. Auction rate securities are generally long-term fixed income instruments that provide liquidity through a Dutch auction process that resets the applicable interest rate at pre-determined calendar intervals, typically every 7, 28, 35 or 49 days. These investments have high credit quality ratings of at least AAA/Aaa. Due to liquidity issues that have recently been experienced in global credit and capital markets, certain of the auction rate securities we hold have failed at auction, meaning that the amount of securities submitted for sale at auction exceeded the amount of purchase orders. If an auction fails, the issuer becomes obligated to pay interest at penalty rates, and all of the auction rate securities we hold continue to pay interest in accordance with their stated terms. However, the failed auctions create uncertainty as to the liquidity in the near term of these securities. As a result, we have classified the \$5.8 million of auction rate securities we held at September 30, 2008 as long-term investments.

As of September 30, 2008, our principal sources of liquidity consisted of cash, cash equivalents and short-term investments of \$64.2 million. Based on our expected operating cash flows, and our other sources of cash, we do not expect the potential lack of liquidity in our auction rate securities classified as long-term investments to affect our ability to execute our current business plan in the near term. However, the principal represented by these investments will not be accessible to us until one of the following occurs: a successful auction occurs, the issuer redeems the issue, a buyer is found outside of the auction process or the underlying securities have matured. There

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can be no assurance that we would be able in the near term to liquidate these securities on favorable terms, or at all, and if we should require access to these funds sooner than we currently expect, our inability to sell these auction rate securities could adversely affect our liquidity and our financial flexibility.

Our principal uses of cash historically have consisted of both payments to our suppliers for the costs related to the outsourcing of wafer fabrication and outsourced processing fees paid to and materials purchased from third parties, as well as payments for our manufacturing overhead and equipment purchases. Construction of our new Wuxi facility began in the fourth quarter of 2007 and is expected to be completed in two phases. Phase one of our new facility is expected to be completed in the first quarter of 2009 and will house our new research and development institute and operations and management offices. The total cost of phase one is estimated to be \$6.0 million. Phase two of our new facility is expected to be completed within three years in a number of phases. Upon completion of phase two, we expect to have in place manufacturing capacity to meet our future production requirements for both accelerometer products and non-accelerometer products. Total costs of phase two, including construction and machinery, are estimated to be \$30 million. We intend to finance substantially all of our new facility with a portion of the net proceeds of our recent initial public offering. Other significant cash outlays primarily consist of salaries, wages and commissions for our non-manufacturing related employees.

We believe that our current cash and cash flow from operations will be sufficient to meet our anticipated cash needs, including working capital requirements and capital expenditures for at least the next twelve months. Our future cash requirements will depend on many factors, including our operating income, the timing of our new product introductions, the costs to maintaining adequate manufacturing capacity, the continuing market acceptance of our products, payment terms for major contracts and customers, or other changing business conditions and future developments, including any investments or acquisitions we may decide to pursue. If our existing cash is insufficient to meet our requirements, we may seek to sell additional equity securities, debt securities or borrow from banks. We cannot assure you that financing will be available in the amounts we need or on terms acceptable to us, if at all. The sale of additional equity securities, including convertible debt securities, would be dilutive to our stockholders. The incurrence of indebtedness would divert cash for working capital requirements and capital expenditures to service debt and could result in operating and financial covenants that restrict our operations and our ability to pay dividends to our stockholders. If we are unable to obtain additional equity or debt financing, our business, operations and prospects may suffer.

***Operating Activities***

Net cash provided by operating activities for the nine months ended September 30, 2008 was \$0.9 million, which was derived from a net income of \$0.2 million adjusted to reflect a net increase relating to non-cash items and a net decrease relating to changes in balances of operating assets and liabilities. The adjustments relating to non-cash items, which resulted in a net increase in cash of \$2.0 million, were primarily due to depreciation and amortization expense of \$1.2 million, stock-based compensation expense of \$1.0 million, excess tax benefit from stock-based compensation of \$96,000 and deferred income tax of \$80,000. The adjustments related to changes in balances of operating assets and liabilities, which resulted in a net decrease in cash of \$1.3 million, were primarily attributable to a \$2.1 million reduction in accounts payable and accrued expenses, and initial public offering expenses; \$1.2 million increase in inventories, primarily due to a decrease in sales forecast; and a \$0.8 million increase in other assets, primarily due to an increase in certain prepaid expenses, offset by a \$2.8 million reduction of account receivables due to collection of payments.

***Investing Activities***

Net cash provided in investing activities for the nine months ended September 30, 2008 was \$36.2 million, primarily consisting of proceeds from sale of short-term investments of \$59.8 million, which was offset by the purchase of property and equipment for expanding our manufacturing capacity of \$4.9 million and the purchase of short-term investments of \$19.0 million.

***Financing Activities***

Net cash provided by financing activities for the nine months ended September 30, 2008 was \$6.8 million, primarily due to the underwriters exercise of their over-allotment option in January 2008, resulting in net proceeds of \$7.6 million, which was offset by the payment of a bank loan of \$1.0 million.

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### **Off-Balance Sheet Arrangements**

We do not have any off-balance sheet financing arrangements, other than property and equipment operating leases, nor do we have any transactions, arrangements or other relationships with any special purpose entities established by us, at our direction or for our benefit.

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

*Interest rate risk.* Currently, our exposure to interest rate risk primarily relates to the interest income generated by excess cash invested in deposits as well as short-term securities. We have not historically used and do not expect to use in the future any derivative financial instruments to manage our interest risk exposure. Interest-earning instruments carry a degree of interest rate risk. We have not been exposed nor do we anticipate being exposed to material risks due to changes in interest rates.

At September 30, 2008, our Wuxi subsidiary, MEMSIC Semiconductor, had an interest-bearing note payable. We believe we have effectively managed the interest rate risk by entering into a fixed rate loan.

*Foreign exchange risk.* The value of the RMB against the U.S. dollar and other currencies may fluctuate and is affected by, among other things, changes in China's political and economic conditions. The conversion of RMB into foreign currencies, including U.S. dollars, has been based on rates set by the People's Bank of China. On July 21, 2005, the PRC government changed its decade-old policy of pegging the value of the RMB to the U.S. dollar. Under this new policy, the RMB is permitted to fluctuate within a narrow and managed band against a basket of certain foreign currencies. While the international reaction to the RMB revaluation has generally been positive, there remains significant international pressure on the PRC government to adopt an even more flexible currency policy, which could result in a further and more significant appreciation of the RMB against the U.S. dollar. Although all of our revenue and a significant portion of our payments are denominated in U.S. dollars, a large portion of our payments are denominated in RMB. Fluctuations in exchange rates, primarily those involving the U.S. dollar, may affect our costs and operating margins as well as our net income reported in U.S. dollars. We have not used any forward contracts or currency borrowings to hedge our exposure to foreign currency exchange risk.

*Market risk; auction rate securities.* As of September 30, 2008, our investments included \$5.8 million of auction rate securities. We have determined that no other-than-temporary impairment in the value of these securities existed as of September 30, 2008. However, we have classified these securities as long-term investments. If the credit and capital markets deteriorate further, the credit ratings of the issuers or the insurers of the auction rate securities are downgraded or the collateral underlying the securities deteriorates or other events occur that would affect the fair value of these auction rate securities, we might conclude that some or all of them have sustained an other-than-temporary impairment in value, such that we would be required under GAAP to write down their carrying value. Any such write-down would result in a charge against our earnings in the period in which the impairment is recognized, which could be material.

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

#### **A. Evaluation of Disclosure Controls and Procedures**

Based on the evaluation of our disclosure controls and procedures (as defined in the Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)) required by Exchange Act Rules 13a15(b) or 15d-15(b), our Chief Executive Officer and our Principal Financial and Accounting Officer have concluded that as of September 30, 2008, the end of the period covered by this report, our disclosure controls and procedures were effective.

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### **B. Changes in Internal Controls**

There were no changes in our internal control over financial reporting, as such term is defined in Exchange Act Rules 13a-15(f) and 15d-15(f), that occurred during the fiscal quarter ended September 30, 2008 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## **PART II - OTHER INFORMATION**

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

From time to time, we are a party to various legal proceedings incidental to our business. However, we have no legal proceedings currently pending that are expected to be material to our operations or financial presentation.

### **Item 1A. Risk Factors**

There has been no material change in the risk factors disclosed under the heading "Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2007, except as follows:

*Current macro-economic conditions, including the credit crisis affecting the financial markets and the possibility of a global recession, could adversely affect our business, results of operations and financial condition in the remainder of 2008 and beyond, and could result in:*

reduced demand for our products;

increased risk of order cancellations or delays;

increased risk of excess and obsolete inventories;

increased pressure on the prices for our products;

greater difficulty in collecting accounts receivable; and

risks to our liquidity, including the possibility that we might not have access to our cash and cash equivalents or to our bank line of credit when needed.

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

The net proceeds to us of our initial public offering, after deducting underwriting discounts and offering expenses, were approximately \$60.2 million. Through September 30, 2008, we have applied approximately \$2.2 million of the net proceeds to fund capital expenditures for the expansion of our manufacturing facility in Wuxi and \$2.7 million to the construction of two new buildings adjacent to that facility. We invested the balance of \$55.3 million of the net proceeds from our initial public offering in money market funds and auction rate securities, pending other uses.





**Table of Contents****Item 6. Exhibits**

| Exhibit<br>No. | Description   | Filed with<br>This<br>Form 10-Q | Incorporated by Reference |                    | Exhibit<br>No. |
|----------------|---|---------------------------------|---------------------------|--------------------|----------------|
|                |   |                                 | Form                      | Filing Date        |                |
| 3.1            | Second Amended and Restated Certificate of Incorporation of MEMSIC, Inc.                    |                                 | 8-K                       | December 19, 2007  | 3.1            |
| 3.2            | Amended and Restated By-Laws of MEMSIC, Inc.  |                                 | S-1/A                     | November 30, 2007  | 3.4            |
| 4.1            | Form of common stock certificate.   |                                 | S-1/A                     | December 7, 2007   | 4.2            |
| 4.2            | Fifth Amended and Restated Investor Rights Agreement.                                       |                                 | S-1                       | September 28, 2007 | 4.3            |
| 31.1           | Chief Executive Officer certification required by Rule 13a-14(a)                            | X                               |                           |                    |                |
| 31.2           | Principal Accounting Officer certification required by Rule 13a-14(a)                       | X                               |                           |                    |                |
| 32.1           | Chief Executive Officer certification pursuant to 18 U.S.C. Section 1350                    | X                               |                           |                    |                |
| 32.2           | Principal Financial and Accounting Officer certification pursuant to 18 U.S.C. Section 1350 | X                               |                           |                    |                |

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**SIGNATURES**

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

**MEMSIC, Inc.**

**Dated: November 14, 2008**

**By: /S/ YANG ZHAO  
Yang Zhao  
Chief Executive Officer and President  
Principal Executive Officer**

**Dated: November 14, 2008**

**By: /S/ PATRICIA NIU  
Patricia Niu  
Principal Financial and Accounting Officer**