STANDARD MICROSYSTEMS CORP
Form 10-Q
January 13, 2004

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended November 30, 2003

OR

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

Commission file number 0-7422

STANDARD MICROSYSTEMS CORPORATION

(Exact name of registrant as specified in its charter)

DELAWARE 11-2234952

(State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification No.)

80 Arkay Drive, Hauppauge, New York 11788

(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code: 631-435-6000

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 _X_ No ____

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

As of November 30, 2003, there were 17,990,546 shares of the registrant's common stock outstanding.

Standard Microsystems Corporation
Form 10-Q
For the Quarter Ended November 30, 2003

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PART I - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

STANDARD MICROSYSTEMS CORPORATION
AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS (unaudited)
(In thousands)

	November 30, 2003	February 28, 2003
Assets		
Current assets:		
Cash and cash equivalents	$ 125,186	$ 90,025
Short-term investments	36,752	22,872
Accounts receivable, net	21,544	22,738
Inventories	21,600	17,644
Deferred income taxes	13,411	8,545
Other current assets	5,164	8,710
Total current assets	223,657	170,534
Property, plant and equipment, net	19,852	22,257
Goodwill	29,595	29,773
Intangible assets, net	5,014	6,008
Deferred income taxes	8,916	11,779
Other assets	5,760	7,598
	$ 292,794	$ 247,949
Liabilities and shareholders' equity		
Current liabilities:		
Accounts payable	$ 11,648	$ 9,114
Deferred income on shipments to distributors	6,614	5,943
Accrued expenses, income taxes and other liabilities	11,675	9,838
Total current liabilities	29,937	24,895

Other liabilities	6,956	7,379
Minority interest in subsidiary	11,802	11,663
Shareholders' equity:		
Preferred stock	-	-
Common stock	1,981	1,859
Additional paid-in capital	167,628	147,655
Retained earnings	95,475	77,492
Treasury stock, at cost	(23,454)	(23,454)
Deferred stock-based compensation	(2,016)	(2,102)
Accumulated other comprehensive income	4,485	2,562
Total shareholders' equity	244,099	204,012
	$ 292,794	$ 247,949

See Notes to Condensed Consolidated Financial Statements.

STANDARD MICROSYSTEMS CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (Unaudited)
(In thousands, except per share data)

	Three Months Ended November 30,	
	2003	2002
Sales and revenues:		
Product sales	$ 52,282	$ 40,293
Intellectual property revenues	20,467	305
	72,749	40,598
Cost of goods sold	30,350	22,653
Gross profit	42,399	17,945
Operating expenses (income):		
Research and development	10,244	8,037
Selling, general and administrative	11,570	9,534
Amortization of intangible assets	317	360
Gains on real estate transactions	-	-
Income from operations	20,268	14
Interest income	617	496
Impairment of investments	-	(16,306)
Other expense, net	(145)	(78)
Income (loss) before provision for (benefit from) income taxes and minority interest	20,740	(15,874)
Provision for (benefit from) income taxes	5,910	(6,854)

Minority interest in net income of subsidiary	43	12
Income (loss) from continuing operations	14,787	(9,032)
Loss from discontinued operations (net of income tax benefits of $2, $69, $108, and $260)	(3)	(125)
Net income (loss)	$ 14,784	$ (9,157)
Basic net income (loss) per share:		
Income (loss) from continuing operations	$ 0.84	$ (0.54)
Loss from discontinued operations	-	(0.01)
Basic net income (loss) per share	$ 0.84	$ (0.55)
Diluted net income (loss) per share:		
Income (loss) from continuing operations	$ 0.77	$ (0.54)
Loss from discontinued operations	-	(0.01)
Diluted net income (loss) per share	$ 0.77	$ (0.55)
Weighted average common shares outstanding:		
Basic	17,577	16,718
Diluted	19,242	16,718

See Notes to Condensed Consolidated Financial Statements.

STANDARD MICROSYSTEMS CORPORATION
AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)
(In thousands)

	Nine Months Ended
	2003
Cash flows from operating activities:	
Cash received from customers and licensees	$ 164,609
Cash paid to suppliers and employees	(131,263)
Interest received	1,361
Interest paid	(51)
Income taxes paid	(363)
Net cash provided by operating activities	34,293
Cash flows from investing activities:	
Capital expenditures	(7,563)
Sales of property, plant and equipment	7,121
Acquisition of Gain Technology Corporation	-
Sales of long-term investments	2,114
Purchases of short-term investments	(36,675)
Sales of short-term investments	22,795

Other	139
Net cash used for investing activities	(12,069)
Cash flows from financing activities:	
Proceeds from issuance of common stock	13,698
Purchases of treasury stock	-
Repayments of obligations under capital leases and notes payable	(1,249)
Net cash provided by (used for) financing activities	12,449
Effect of foreign exchange rate changes on cash and cash equivalents	789
Cash used for discontinued operation	(301)
Net increase (decrease) in cash and cash equivalents	35,161
Cash and cash equivalents at beginning of period	90,025
Cash and cash equivalents at end of period	$ 125,186

Reconciliation of income (loss) from continuing operations to net cash provided by operating activities:	
Income (loss) from continuing operations	$ 18,176
Adjustments to reconcile income (loss) from continuing operations to net cash provided by operating activities:	
Depreciation and amortization	8,142
Tax benefits from employee stock plans	5,615
Gains from sales of investments and property, net	(686)
Asset impairment charges	-
Other adjustments, net	(197)
Changes in operating assets and liabilities:	
Accounts receivable	1,512
Inventories	(3,444)
Accounts payable and accrued expenses and other liabilities	3,891
Current and deferred income taxes	1,136
Other changes, net	148
Net cash provided by operating activities	$ 34,293

See Notes to Condensed Consolidated Financial Statements.

STANDARD MICROSYSTEMS CORPORATION
AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

1. Basis of Presentation

The accompanying unaudited condensed consolidated financial information of Standard Microsystems Corporation and subsidiaries, referred to herein as "SMSC" or "the Company", has been prepared in accordance with generally accepted accounting principles and the rules and regulations of the Securities and Exchange Commission, and reflects all adjustments, consisting only of normal recurring adjustments, which in management's

opinion are necessary to state fairly the Company's financial position, results of operations and cash flows for all periods presented.

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements, as well as the reported amounts of sales and revenues and expenses during the reporting period. Actual results may differ from those estimates, and such differences may be material to the financial statements. These condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements for the year ended February 28, 2003 included in the Company's annual report on Form 10-K, as filed on May 29, 2003 with the Securities and Exchange Commission. The results of operations for the three and nine months ended November 30, 2003 are not necessarily indicative of the results to be expected for any future periods.

2. Stock-Based Compensation

The Company has in effect several stock-based compensation plans under which incentive stock options, non-qualified stock options and restricted stock awards are granted to employees and directors. All stock options are granted with exercise prices equal to the fair value of the underlying shares on the date of grant. The Company accounts for stock option grants in accordance with Accounting Principles Board (APB) Opinion No. 25, "Accounting for Stock Issued to Employees" and accordingly recognizes no compensation expense for the stock option grants. Additional pro forma disclosures as required under Statement of Financial Accounting Standards (SFAS) No. 123, "Accounting for Stock-Based Compensation", as amended by SFAS No. 148, "Accounting for Stock-Based Compensation - Transition and Disclosure", are detailed below.

For purposes of pro forma disclosures, the estimated fair market value of the Company's options is amortized as an expense over the options' vesting periods. The fair value of each option grant, as defined by SFAS No. 123, is estimated on the date of grant using the Black-Scholes option-pricing model. The Black-Scholes model, as well as other currently accepted option valuation models, was developed to estimate the fair value of freely tradable, fully transferable options without vesting restrictions, that significantly differ from the Company's stock option awards. Because the Company's employee stock options have characteristics significantly different from those of traded options, and because changes in the subjective input assumptions can materially affect the fair value estimate, in the opinion of management, the existing models do not necessarily provide a reliable single measure of the fair value of employee stock options.

Had compensation expense been recorded under the provisions of SFAS No. 123, the Company's net income (loss) and net income (loss) per share would have been the pro forma amounts indicated below (in thousands, except per share data):

	Three Months Ended November 30,		Nine Mon Novem
	2003	2002	2003
Net income (loss) - as reported	$ 14,784	$ (9,157)	$ 17,983
Stock-based compensation expense included in net income, net of taxes - as reported	232	200	691

Stock-based compensation expense determined using fair value method, net of taxes	2,916	(2,190)	(1,775
Net income (loss) - pro forma	$ 17,932	$ (11,147)	$ 16,899
Basic net income (loss) per share - as reported	$ 0.84	$ (0.55)	$ 1.05
Diluted net income (loss) per share - as reported	$ 0.77	$ (0.55)	$ 0.99
Basic net income (loss) per share - pro forma	$ 1.02	$ (0.67)	$ 0.99
Diluted net income (loss) per share - pro forma	$ 1.02	$ (0.67)	$ 0.99

3. Balance Sheet Data

Inventories are valued at the lower of first-in, first-out cost or market and consist of the following (in thousands):

	Nov. 30, 2003	Feb. 28, 2003
Raw materials	$ 502	$ 761
Work in process	8,776	7,686
Finished goods	12,322	9,197
	$ 21,600	$ 17,644

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

	Nov. 30, 2003	Feb. 28,2003
Land	$ 1,571	$ 3,434
Buildings and improvements	20,707	29,927
Machinery and equipment	84,410	81,562
	106,688	114,923
Less: accumulated depreciation	86,836	92,666
	$ 19,852	$ 22,257

During the three months ended May 31, 2003, the Company sold certain portions of its real estate holdings, further details for which appear within Note 11.

4. Net Income Per Share

Basic net income per share is calculated using the weighted-average number of common shares outstanding during the period. Diluted net income per share is calculated using the weighted-average number of common shares outstanding during the period, plus the dilutive effect of shares issuable through stock options.

The shares used in calculating basic and diluted net income per share for the Condensed Consolidated Statements of Operations included within this

report are reconciled as follows (in thousands):

	Three Months Ended November 30,		Nine Months E November 30
	2003	2002	2003
Average shares outstanding for basic net income (loss) per share	17,577	16,718	17,120
Dilutive effect of stock options	1,665	-	1,023
Average shares outstanding for diluted net income (loss) per share	19,242	16,718	18,143

Options covering 0.3 million and 1.4 million shares for the three-month periods ended November 30, 2003 and 2002, respectively, and 1.6 million and 0.8 million shares for the nine-month periods ended November 30, 2003 and 2002, respectively, were excluded from the computation of average shares outstanding for diluted net income per share because their effect was antidilutive.

5. Comprehensive Income

The Company's other comprehensive income consists of foreign currency translation adjustments from those subsidiaries not using the U.S. dollar as their functional currency, and unrealized gains and losses on equity investments classified as available-for-sale. The components of the Company's comprehensive income (loss) for the three and nine months ended November 30, 2003 and 2002 were as follows (in thousands):

	Three Months Ended November 30,		Nine Months November 3
	2003	2002	2003
Net income (loss)	$ 14,784	$ (9,157)	$ 17,983
Other comprehensive income (loss):			
Change in foreign currency translation adjustment	995	(509)	1,211
Change in unrealized gain (loss) on marketable equity securities, net of taxes	12	22	47
Reclassification adjustment for loss on marketable equity security included in net income, net of taxes	-	3,542	665
Total comprehensive income (loss)	$ 15,791	$ (6,102)	$ 19,906

During the nine months ended November 30, 2003, the Company sold its remaining equity investment in Chartered Semiconductor Manufacturing, Ltd. This investment was classified as available-for-sale, and temporary changes

in its market value, net of income taxes, were included within the Company's Other comprehensive income, and were presented cumulatively as an unrealized gain or loss, net of income taxes, within Accumulated other comprehensive income on the Company's Consolidated Balance Sheets. The amounts presented as reclassification adjustments in the preceding table represent the amounts previously reported within Other comprehensive income as an unrealized loss on this investment, net of income taxes, through the applicable reporting dates.

6. Agreements with Intel Corporation

As previously reported, the Company and Intel Corporation (Intel) entered into an agreement in 1987 providing for, among other things, a broad, worldwide, non-exclusive patent cross-license, covering manufacturing processes and products, thereby providing each company access to the other's current and future patent portfolios.

In September 2003, the Company and Intel announced that they had enhanced their intellectual property and business relationship. The companies agreed to collaborate on certain future I/O and sensor products, and Intel agreed to use the Company's devices on certain current and future generations of Intel products. In addition, the Company agreed to limit its rights under its 1987 patent cross-license with Intel to manufacture and sell Northbridge products and Intel Architecture Microprocessors on behalf of third parties. The companies also terminated an Investor Rights Agreement between them, which had been entered into in connection with Intel's 1997 acquisition of 1,543,000 shares of the Company's common stock. Under this agreement, Intel had certain information, corporate governance and other rights with respect to the activities of the Company.

In respect of this new relationship, Intel will pay to the Company an aggregate amount of $75 million, of which $20 million was paid and recognized as intellectual property revenue in the third quarter of the Company's fiscal 2004, $10 million will be paid in each of calendar years 2004 and 2005, $11 million will be paid in calendar year 2006, and $12 million will be paid in each of calendar years 2007 and 2008. Such amounts are payable in equal quarterly installments within each calendar year, and are subject to possible reduction, in a manner and to an extent to be agreed by the parties, based upon the companies' collaboration and sales, facilitated by Intel, of certain future new products of the Company.

7. Business Acquisition

In June 2002, the Company acquired all of the outstanding common stock of Gain Technology Corporation (Gain), a developer and supplier of high-speed, high-performance analog and mixed-signal communications integrated circuits and proprietary intellectual property cores, based in Tucson, Arizona, for $36.1 million.

The unaudited pro forma results of operations for the nine months ended November 30, 2002 set forth below give effect to the acquisition of Gain as if it had occurred at the beginning of fiscal 2003. Pro forma data is subject to certain assumptions and estimates, and is presented for informational purposes only. This data does not purport to be indicative of the results that would have actually occurred had the acquisition occurred on the basis described above, nor do they purport to be indicative of future operating results.

	Nine Months Ended November 30, 2002	
(in thousands, except per share data)	Autual	Pro forma

Sales and revenues	$ 112,905	$ 114,143
Net loss	(8,495)	(9,338)
Basic and diluted net loss per share	$ (0.52)	$ (0.54)

8. Business Restructuring

In December 2001, the Company announced a restructuring plan for its exit from the PC chipset business.

A summary of the activity in the reserve related to this restructuring for the nine months ended November 30, 2003 is as follows (in thousands):

	Non-cancelable lease obligations	Other Charges	Total
Business restructuring reserve at February 28, 2003	$ 1,374	$ 45	$ 1,419
Cash payments	(309)	-	(309)
Business restructuring reserve at November 30, 2003	$ 1,065	$ 45	$ 1,110

Payments related to non-cancelable lease obligations are being paid over their respective terms through August 2008.

9. Discontinued Operations

The Company had been involved in an arbitration with Accton Technology Corporation (Accton) and SMC Networks, Inc. (Networks) related to claims associated with the purchase of an 80.1% interest in Networks by Accton from SMSC in October 1997. This divestiture was accounted for as a discontinued operation, and accordingly, costs associated with this action, net of income taxes, are reported as a Loss from discontinued operations on the Consolidated Statements of Operations. These costs were nominal during the three months ended November 30, 2003, compared to $0.1 million for the three months ended November 30, 2002, after applicable income tax benefits. These costs totaled $0.2 million and $0.5 million in the nine-month periods ended November 30, 2003 and 2002, respectively, after applicable income tax benefits.

In September 2003, the arbitration panel issued its decision in this action, which directed the release of a $2.5 million escrow account to SMSC and awarded certain other payments among the parties.

In December 2003, the parties reached a final settlement of the award, resulting in SMSC receiving $2.7 million in cash and realizing a gain of $0.1 million, after income taxes, which will be reported as a Gain on discontinued operations in the quarter ending February 29, 2004.

10. Goodwill and Intangible Assets

The Company's June 2002 acquisition of Gain Technology Corporation included the acquisition of $7.1 million of finite-lived intangible assets and $29.6 million of goodwill, after adjustments. During the nine months ended November 30, 2003, the Company reduced the amount of goodwill relating to this transaction from $29.8 million to $29.6 million, reflecting the resolution of certain contingencies at amounts different than originally estimated. In accordance with the provisions of SFAS No. 142, this goodwill

is not amortized, but is tested for impairment in value annually, as well as when an event or circumstance occurs indicating a possible impairment in its value.

All finite-lived intangible assets are being amortized on a straight-line basis over their estimated useful lives. Existing technologies were assigned an estimated useful life of six years. Customer contracts were assigned useful lives of between one and ten years (with a weighted average life of approximately seven years), and non-compete agreements were assigned useful lives of two years. The weighted average useful life of all intangible assets is approximately six years.

As of November 30, 2003, the Company's finite-lived intangible assets consisted of the following (in thousands):

	Cost	Accumulated Amortization	Net
Existing technologies	$ 6,179	$ 1,545	$ 4,634
Customer contracts	326	49	277
Non-compete agreements	410	307	103
	$ 6,915	$ 1,901	$ 5,014

Estimated future intangible asset amortization expense for the remainder of fiscal 2004, and for the five fiscal years thereafter, is as follows (in thousands):

Period	Amount
Remainder of fiscal 2004	$ 317
Fiscal 2005	1,114
Fiscal 2006	1,062
Fiscal 2007	1,062
Fiscal 2008	1,062
Fiscal 2009	290

11. Real Estate Transactions

During the first quarter of fiscal 2004, the Company sold certain portions of its Hauppauge, New York real estate holdings, for aggregate proceeds of $7.0 million, net of transaction costs. These transactions resulted in an aggregate gain of $1.7 million, $1.4 million of which related to property in which the Company has no continued interest and was recognized within the Company's fiscal 2004 first quarter operating results, and $0.3 million of which related to property that the Company has leased back from the purchaser and has therefore been deferred. This deferred gain is being recognized within the Company's operating results as a reduction of rent expense on a straight-line basis over a 30-month period beginning in June 2003, consistent with the term of the lease. The Company's remaining rent obligation over the term of this lease is approximately $0.7 million.

12. Sales of Equity Investment

During the three months ended May 31, 2003, the Company sold its remaining equity investment in Chartered Semiconductor Manufacturing, Ltd., realizing a loss of $0.7 million, which is included within Other expense, net.

13. Litigation

In June 2003, Standard Microsystems Corporation was named as a defendant in a patent infringement lawsuit filed by Analog Devices, Inc. (ADI) in the United States District Court for the District of Massachusetts (Analog Devices, Inc. v. Standard Microsystems Corporation, Case Number 03 CIV 11216). The Complaint, as amended, alleges that some of the Company's products infringe one or more of three of ADI's patents, and seeks injunctive relief and unspecified damages. In September 2003, the Company filed an Answer in the lawsuit, denying ADI's allegations and raising affirmative defenses and counterclaims. Although it is premature to assess the outcome of the litigation, the Company believes that the allegations against it are without merit.

14. Recent Accounting Pronouncements

In November 2002, the Emerging Issues Task Force (EITF), reached a consensus on EITF Issue No. 00-21, "Revenue Arrangements with Multiple Deliverables." EITF Issue No. 00-21 requires revenue arrangements with multiple deliverables to be divided into separate units of accounting if the deliverables in the arrangement meet certain criteria. The arrangement's consideration should be allocated among the separate units of accounting based on their relative fair values. Applicable revenue recognition criteria should be considered separately for each unit. The provisions of EITF Issue No. 00-21 are effective for revenue arrangements entered into in fiscal periods beginning after June 15, 2003. The adoption of this standard did not have a material impact on the Company's financial condition or results of operations.

In December 2002, the FASB issued Statement of Financial Accounting Standards (SFAS) No. 148, "Accounting for Stock-Based Compensation - Transition and Disclosure - an Amendment of SFAS No. 123", which is effective for financial statements for fiscal years ending after December 15, 2002, with early adoption permitted. SFAS No. 148 will enable companies that choose to adopt the fair value based method to report the full effect of employee stock options in their financial statements immediately upon adoption, and to make available to investors better and more frequent disclosure about the cost of employee stock options. The Company will continue to apply the disclosure-only provisions of both SFAS No. 123 and SFAS No. 148.

In April 2003, the FASB issued SFAS No. 149, "Amendment of Statement 133 on Derivative Instruments and Hedging Activities". This statement amends and clarifies financial accounting and reporting for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities under SFAS No. 133. SFAS No. 149 is effective for contracts entered into or modified after June 30, 2003. The adoption of this standard did not have a material impact on the Company's financial condition or results of operations.

In May 2003, the FASB issued SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity". SFAS No. 150 establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity, and requires that an issuer classify a financial instrument that is within its scope as a liability (or as an asset, in some circumstances). Many of those instruments were previously classified as equity. SFAS No. 150 is effective for financial instruments entered into or modified after May 31, 2003. It is to be implemented by reporting the cumulative effect of a change in an accounting principle for financial instruments created before the issuance date of SFAS No. 150 and still existing at the beginning of the interim period of adoption. The adoption of this standard did not have a material impact on the Company's financial condition or results of operations.

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

The following discussion should be read in conjunction with the Company's consolidated condensed financial statements and notes thereto contained in this report.

Portions of this report may contain forward-looking statements about expected future events and financial and operating results that involve risks and uncertainties. These include, among others, the timely development and market acceptance of new products; the impact of competitive products and pricing; the effect of changing economic conditions in domestic and international markets; changes in customer order patterns, including loss of key customers, order cancellations or reduced bookings; and excess or obsolete inventory and variations in inventory valuation. Words such as "believe," "expect," "anticipate" and similar expressions identify forward-looking statements. Such statements are qualified in their entirety by the inherent risks and uncertainties surrounding future expectations and may not reflect the potential impact of any future acquisitions, mergers or divestitures.

Standard Microsystems Corporation (the Company or SMSC) competes in the semiconductor industry, which has historically been characterized by intense competition, rapid technological change, cyclical market patterns, price erosion and periods of mismatched supply and demand. In addition, sales of many of the Company's products depend largely on sales of personal computers and peripheral devices, and reductions in the rate of growth of the PC and non-PC markets could adversely affect its operating results. SMSC conducts business outside the United States and is subject to tariff and import regulations and currency fluctuations, which may have an effect on its business. All forward-looking statements speak only as of the date hereof and are based upon the information available to SMSC at this time. Such information is subject to change, and the Company will not necessarily inform investors of such changes, except as required by law. These and other risks and uncertainties, including potential liability resulting from pending or future litigation, are detailed from time to time in the Company's reports filed with the Securities and Exchange Commission (SEC). Investors are advised to read the Company's Annual Report on Form 10-K filed with the SEC, particularly the section entitled "Other Factors That May Affect Future Operating Results", for a more complete discussion of these and other risks and uncertainties.

Overview

Description of Business

SMSC is a designer and worldwide supplier of advanced digital, mixed-signal and analog semiconductor solutions for a broad range of communications and computing applications in the areas of Advanced Input/Output (I/O), USB connectivity, networking and embedded communications and control systems. The Company is a fabless semiconductor supplier whose products are manufactured by world-class third-party semiconductor foundries and assemblers. To ensure the highest product quality, the Company conducts a significant portion of its final testing requirements in the Company's own state-of-the-art testing operation.

The Company is prominent as the world's leading supplier of Advanced I/O integrated circuits for desktop and mobile personal computers. Advanced I/O circuits contain a variety of individual functions ranging from legacy PC I/O to leading edge system management, including flash memory, infrared communications support, a real-time clock, and power management.

The Company serves the networking and connectivity markets with its families of integrated Ethernet and USB 2.0 products, along with other products, that provide solutions for the needs of network printers, set-top boxes, home gateway products, automobile navigation systems, cellular base stations, USB peripheral devices and a variety of other machine-to-machine communications applications.

The Company's headquarters are located in Hauppauge, New York, and SMSC operates design and validation centers in New York, Austin, Texas, Tucson, Arizona and Phoenix, Arizona, and has sales offices in the United States, Europe, Taiwan, Korea and China. The Company conducts most of its business in the Japanese market through its majority-owned subsidiary, SMSC Japan.

Strategic Business Agreement

As previously reported, the Company and Intel Corporation (Intel) entered into an agreement in 1987 providing for, among other things, a broad, worldwide, non-exclusive patent cross-license, covering manufacturing processes and products, thereby providing each company access to the other's current and future patent portfolios.

In September 2003, the Company and Intel announced that they had enhanced their intellectual property and business relationship. The companies agreed to collaborate on certain future I/O and sensor products, and Intel agreed to use the Company's devices on certain current and future generations of Intel products. In addition, the Company agreed to limit its rights under its 1987 patent cross-license with Intel to manufacture and sell Northbridge products and Intel Architecture Microprocessors on behalf of third parties. The companies also terminated an Investor Rights Agreement between them, which had been entered into in connection with Intel's 1997 acquisition of 1,543,000 shares of the Company's common stock. Under this agreement, Intel had certain information, corporate governance and other rights with respect to the activities of the Company.

In respect of this new relationship, Intel will pay to the Company an aggregate amount of $75 million, of which $20 million was paid and recognized as intellectual property revenue in the third quarter of the Company's fiscal 2004, $10 million will be paid in each of calendar years 2004 and 2005, $11 million will be paid in calendar year 2006, and $12 million will be paid in each of calendar years 2007 and 2008. Such amounts are payable in equal quarterly installments within each calendar year, and are subject to possible reduction, in a manner and to an extent to be agreed by the parties, based upon the companies' collaboration and sales, facilitated by Intel, of certain future new products of the Company.

Critical Accounting Policies and Estimates

This discussion and analysis of the Company's financial condition and results of operations is based upon the unaudited consolidated condensed financial statements included in this report, which have been prepared in accordance with accounting principles for interim financial statements generally accepted in the United States. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amount of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amount of sales and revenues and expenses during the reporting period.

The Company believes that the critical accounting policies and estimates listed below are important to the portrayal of the Company's financial condition and operating results, and require critical management judgments and estimates about matters that are inherently uncertain. Although management believes that its judgments and estimates are appropriate and reasonable, actual future results may differ from these estimates, and to the extent that such differences are material, future reported operating results may be affected.

- Revenue recognition
- Inventory valuation
- Determination of the allowance for doubtful accounts receivable
- Valuation of long-lived assets

- Accounting for deferred income tax assets
- Legal contingencies

Further information regarding these policies appears within the "Management's Discussion and Analysis of Financial Condition and Results of Operations" included in the Company's annual report on Form 10-K for the fiscal year ended February 28, 2003 filed with the SEC on May 29, 2003. During the nine-month period ended November 30, 2003, there were no significant changes to any critical accounting policies or to the related estimates and judgments involved in applying these policies.

Results of Operations

Sales and Revenues

Sales and revenues for the three months ended November 30, 2003 were $72.7 million, an increase of approximately 79% compared to $40.6 million reported in the third quarter of the prior fiscal year. For the nine months ended November 30, 2003, sales and revenues were $163.8 million, compared to $112.9 million in the prior year nine-month period, an increase of 45%. Sales and revenues for the three- and nine-month periods ended November 30, 2003 include the initial $20.0 million payment from Intel under the above-described agreement. The Company received no similar payment in the prior-year periods. Without that payment, the increase in sales and revenues over the comparable year-earlier periods would have been 30% for the three-month period and 27% for the nine-month period. These increases reflect higher product sales in the current year periods in all of the Company's major product categories, in terms of both units and dollars, compared to the corresponding prior year periods. Increased PC demand has helped drive increased unit PC I/O shipments. The Company's non-PC products, which are primarily focused in networking and USB connectivity applications, achieved higher product sales from recent new product introductions, as well as the Company's ongoing focus on aggressively identifying and pursuing new market opportunities in these product lines.

Sales and revenues from customers outside of North America accounted for approximately 68% and 81% of the Company's sales and revenues for the three and nine- month periods ended November 30, 2003, respectively, the largest portion of which was to the Asia and Pacific Rim region. These percentages were 94% and 92%, respectively, excluding the $20 million intellectual property payment. The comparable percentages for the three- and nine-month periods in the prior fiscal year were 91% and 90%, respectively. The Company expects that international shipments, particularly to the Asia and Pacific Rim region, will continue to represent a significant portion of its sales and revenues.

Gross Profit

Gross profit for the three months ended November 30, 2003 was $42.4 million, or 58.3% of sales and revenues, compared to $17.9 million, or 44.2% of sales and revenues, for the three months ended November 30, 2002. For the nine months ended November 30, 2003, gross profit was $84.6 million, or 51.6% of sales and revenues, compared to $50.1 million, or 44.4% of sales and revenues, in the prior year nine-month period. Without the $20.0 million intellectual property payment from Intel, gross profit would have been 42.5% and 44.9% of sales and revenues for the three- and nine-month periods ended November 30, 2003, respectively.

The gross profit percentage in the current year's third quarter, without the $20.0 million payment, was impacted by significant shipments of a low-margin part that is no longer shipping in significant volumes. For the current year nine-month period, the improvement in gross profit percentage reflects the $20.0 million intellectual property payment.

Research and Development Expenses

The semiconductor industry, and the individual markets in which the Company currently competes, are highly competitive, and the Company believes that the continued investment in research and development (R&D) is essential to maintaining and improving its competitive position, and to driving its opportunities for future growth.

The Company's research and development activities are performed by a team of highly-skilled and experienced engineers and technicians, and are primarily directed towards the design of new integrated circuits, the development of new software design tools and blocks of logic, as well as ongoing cost reductions and performance improvements in existing products.

R&D expenses were $10.2 million, or approximately 14% of sales and revenues (19% without the $20 million intellectual property payment), for the three months ended November 30, 2003, compared to $8.0 million, or approximately 20% of sales and revenues, for the three months ended November 30, 2002. This dollar increase reflects the impact of engineering staff additions, investments in advanced semiconductor design tools and costs associated with development programs in advanced semiconductor geometries.

For the nine months ended November 30, 2003, R&D expenses were $28.6 million, compared to $22.7 million for the nine months ended November 30, 2002, which equaled approximately 20% of sales and revenues in both periods, after excluding the $20.0 million intellectual property payment from sales and revenues for the current-year period. This increase reflects the impact of the factors noted in the three-month discussion within the preceding paragraph, as well as the impact of the Company's June 2002 acquisition of Gain Technology Corporation (Gain), which added 35 highly skilled engineers and designers to the Company's staff.

Selling, General and Administrative Expenses

Selling, general and administrative expenses were $11.6 million, or approximately 16% of sales and revenues, for the three months ended November 30, 2003, compared to $9.5 million, or approximately 23% of sales and revenues, for the three months ended November 30, 2002. For the current nine-month period, selling, general and administrative expenses were $31.0 million, or approximately 19% of sales and revenues, compared to $26.4 million, or approximately 23% of sales and revenues, in the prior year nine-month period. The dollar increases reflect the impact of additional staff added to expand the Company's sales and marketing capabilities, as well as incremental selling costs, primarily sales commissions and incentives, associated with higher product sales in the current year periods. The increases also reflect $0.8 million of expenses associated with completion of the agreement with Intel. Excluding those expenses and excluding the $20 million intellectual property payment from sales and revenues, selling, general and administrative expenses would have been 20% and 21% of sales and revenues for the three- and nine-month periods ended November 30, 2003, respectively.

Amortization of Intangible Assets

For the three and nine months ended November 30, 2003, the Company recorded amortization expenses of $0.3 million and $1.0 million, respectively, for intangible assets associated with the June 2002 acquisition of Gain. Comparable amortization expense was $0.4 million and $0.8 million, respectively, in the three and nine months ended November 30, 2002.

Gains on Real Estate Transactions

During the first quarter of fiscal 2004, the Company sold certain portions of its Hauppauge, New York real estate holdings, for aggregate proceeds of $7.0 million, net of transaction costs. These transactions resulted in an aggregate gain of $1.7 million, $1.4 million of which related to property in which the Company has no continued interest and was recognized within the Company's fiscal

2004 first quarter operating results, and $0.3 million of which related to property that the Company has leased back from the purchaser and has therefore been deferred. This deferred gain is being recognized within the Company's operating results as a reduction in rent expense on a straight-line basis over a 30-month period beginning in June 2003, consistent with the term of the lease. The Company's remaining rent obligation over the term of this lease is approximately $0.7 million.

Other Income and Expense

During the first quarter of fiscal 2004, the Company sold its remaining equity investment in Chartered Semiconductor Manufacturing, Ltd. (Chartered), realizing losses of $0.7 million, which are included within Other expense, net, for the nine months ended November 30, 2003.

Provision For Income Taxes

The Company's provision for income taxes from continuing operations in the third quarter of fiscal 2004 was $5.9 million, resulting in an effective income tax rate of 28.5%. The benefit from income taxes from continuing operations in the prior fiscal year's third quarter was $6.9 million, resulting in an effective income tax benefit rate of 43.2%. For the nine months ended November 30, 2003, the provision for income taxes from continuing operations was $7.6 million, for an effective rate of 29.3%, compared to a benefit of $6.5 million, for an effective income tax benefit rate of 44.8%, in last year's nine-month period. The Company expects its effective tax rate on income from continuing operations to be approximately 20.0% in fiscal 2004, excluding the income tax effects of special real estate and equity investment sales, special intellectual property revenues and tax benefits related to prior years. Income taxes on the aforementioned special transactions are recorded when they occur, at the Company's incremental income tax rate of approximately 36.0%. The overall expected fiscal 2004 effective tax rate on income from continuing operations, including all special transactions, is expected to be between 27.0% and 28.0%.

The Company's effective income tax rate primarily reflects statutory Federal and state income tax rates, adjusted for the impact of tax-exempt interest income and anticipated income tax credits. Excluding the tax effect of special transactions in both fiscal years, the higher effective rate expected for fiscal 2004, compared to fiscal 2003, recognizes the impact of higher income from continuing operations expected in the current year, which in turn dilutes the percentage impact of income tax credits and tax-exempt interest income on the Company's provision for income taxes.

The provision for income taxes from continuing operation for the nine months ended November 30, 2003 has not been reduced by approximately $5.6 million of income tax benefits related to the Company's stock option plans. This tax benefit has been credited to additional paid-in capital.

Discontinued Operations

The Company has been involved in an arbitration with Accton Technology Corporation (Accton) and SMC Networks, Inc. (Networks) related to claims associated with the purchase of an 80.1% interest in Networks by Accton from SMSC in October 1997. This divestiture was accounted for as a discontinued operation, and accordingly, costs associated with this action, net of income taxes, are reported as a Loss from discontinued operations on the Consolidated Statements of Operations. These costs were nominal during the three months ended November 30, 2003, compared to $0.1 million for the three months ended November 30, 2002, after applicable income tax benefits. These costs totaled $0.2 million and $0.5 million in the nine-month periods ended November 30, 2003 and 2002, respectively, after applicable income tax benefits.

In September 2003, the arbitration panel issued its decision in this action, which directed the release of a $2.5 million escrow account to SMSC and awarded

certain other payments among the parties.

In December 2003, the parties reached a final settlement of the award, resulting in SMSC receiving $2.7 million in cash and realizing a gain of $0.1 million, after income taxes, which will be reported as a Gain on discontinued operations in the quarter ending February 29, 2004.

Liquidity and Capital Resources

The Company currently finances its operations through a combination of existing resources and cash generated by operations.

The Company's cash, cash equivalents and short-term investments increased to $161.9 million as of November 30, 2003, compared to $112.9 million at February 28, 2003. This increase reflects, among other things, receipt of a $20.0 million intellectual property payment, $13.7 million of proceeds from stock issuances under the Company's stock option plans, $7.0 million of cash provided by sales of real estate and $2.1 million of cash provided by sales of the Company's investment in Chartered.

Operating activities generated $34.3 million of cash, including the $20.0 million intellectual property payment, during the nine months ended November 30, 2003. Investing activities consumed $12.1 million of cash for the same period, due principally to $13.9 million of net purchases of short-term investments. Financing activities provided $12.4 million of cash during the first nine months of fiscal 2004, including $13.7 million of proceeds from the issuance of stock under the Company's stock option plans.

The Company's inventories were $21.6 million at November 30, 2003, compared to $17.6 million at February 28, 2003, commensurate with expected demand for the Company's products.

Accounts receivable decreased from $22.7 million at February 28, 2003 to $21.5 million at November 30, 2003, despite the increase in sales and revenues in the three-month periods preceding those dates, due to strong collections. The Company's accounts receivable portfolio remains almost entirely current.

Capital expenditures for the nine months ended November 30, 2003 were $8.7 million, of which $7.6 million was paid in cash. The current year's capital investments include an expenditure of $4.3 million for advanced design tools, which is being financed on a short-term basis by the supplier with payment terms extending through March 1, 2004. As of November 30, 2003, this obligation totals $1.1 million, which is reported within Accounts payable. There were no material commitments for capital expenditures as of November 30, 2003.

During the first nine months of fiscal 2004, the Company did not acquire any additional treasury stock through its common stock repurchase program, under which approximately 1.2 million shares remain authorized for repurchase. As of November 30, 2003, the Company held approximately 1.8 million shares of treasury stock, at a cost of $23.5 million.

The Company has considered in the past, and will continue to consider, various possible transactions to secure necessary foundry manufacturing capacity, including equity investments in, prepayments to, or deposits with foundries, in exchange for guaranteed capacity or other arrangements which address the Company's manufacturing requirements. The Company may also consider utilizing cash to acquire or invest in complementary businesses or products or to obtain the right to use complementary technologies. From time to time, in the ordinary course of business, the Company may evaluate potential acquisitions of or investment in such businesses, products or technologies owned by third parties.

The Company expects that its cash, cash equivalents, short-term investments, cash flows from operations and its borrowing capacity will be sufficient to finance the Company's operating and capital requirements for at least the next 12 months.

Recent Accounting Pronouncements

In November 2002, the Emerging Issues Task Force (EITF) reached a consensus on EITF Issue No. 00-21, "Revenue Arrangements with Multiple Deliverables." EITF Issue No. 00-21 requires revenue arrangements with multiple deliverables to be divided into separate units of accounting if the deliverables in the arrangement meet certain criteria. The arrangement's consideration should be allocated among the separate units of accounting based on their relative fair values. Applicable revenue recognition criteria should be considered separately for each unit. The provisions of EITF Issue No. 00-21 are effective for revenue arrangements entered into in fiscal periods beginning after June 15, 2003. The adoption of this standard did not have a material impact on the Company's financial condition or results of operations.

In December 2002, the FASB issued Statement of Financial Accounting Standards (SFAS) No. 148, "Accounting for Stock-Based Compensation - Transition and Disclosure - an Amendment of SFAS No. 123", which is effective for financial statements for fiscal years ending after December 15, 2002, with early adoption permitted. SFAS No. 148 will enable companies that choose to adopt the fair value based method to report the full effect of employee stock options in their financial statements immediately upon adoption, and to make available to investors better and more frequent disclosure about the cost of employee stock options. The Company will continue to apply the disclosure-only provisions of both SFAS No. 123 and SFAS No. 148.

In April 2003, the FASB issued SFAS No. 149, "Amendment of Statement 133 on Derivative Instruments and Hedging Activities". This statement amends and clarifies financial accounting and reporting for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities under SFAS No. 133. SFAS No. 149 is effective for contracts entered into or modified after June 30, 2003. The adoption of this standard did not have a material impact on the Company's financial condition or results of operations.

In May 2003, the FASB issued SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity". SFAS No. 150 establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity, and requires that an issuer classify a financial instrument that is within its scope as a liability (or as an asset, in some circumstances). Many of those instruments were previously classified as equity. SFAS No. 150 is effective for financial instruments entered into or modified after May 31, 2003. It is to be implemented by reporting the cumulative effect of a change in an accounting principle for financial instruments created before the issuance date of SFAS No. 150 and still existing at the beginning of the interim period of adoption. The adoption of this standard did not have a material impact on the Company's financial condition or results of operations.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Financial Market Risks

Interest Rate Risk - The Company's exposure to interest rate risk relates primarily to its investment portfolio. The primary objective of the Company's investment portfolio management is to invest available cash while preserving principal and meeting liquidity needs. In accordance with the Company's investment policy, investments are placed with high credit-quality issuers and the amount of credit exposure to any one issuer is limited.

As of November 30, 2003, the Company's $36.8 million of short-term investments consisted primarily of investments in corporate, government and municipal obligations with maturities of between three and twelve months. If market interest rates were to increase immediately and uniformly by 10 percent from levels at November 30, 2003, the Company estimates that the fair value of these short-term investments would decline by an immaterial amount. The Company generally expects to hold its fixed income investments until maturity and, therefore, would not expect operating results or cash flows to be affected to any significant degree by a sudden change in market interest rates on short-term investments.

Equity Price Risk - The Company has no material investments in equity securities of other companies on its Consolidated Balance Sheet as of November 30, 2003.

Foreign Currency Risk - The Company has international sales and expenditures and is, therefore, subject to certain foreign currency rate exposure. The Company conducts a significant amount of its business in Asia. In order to reduce the risk from fluctuation in foreign exchange rates, most of the Company's product sales and all of its arrangements with its foundry, test and assembly vendors are denominated in U.S. dollars. Transactions in the Japanese market made by the Company's majority-owned subsidiary, SMSC Japan, are denominated in Japanese yen. SMSC Japan purchases a significant amount of its products for resale from Standard Microsystems Corporation in U.S. dollars, and from time to time enters into forward exchange contracts to hedge against currency fluctuations associated with these product purchases. During fiscal 2003, SMSC Japan entered into a contract with a Japanese financial institution to purchase U.S. dollars to meet a portion of its U.S. dollar denominated product purchase requirements. Gains and losses on this contract, which expired in March 2003, were not significant.

The Company has never received a cash dividend (repatriation of cash) from SMSC Japan.

Other Factors That May Affect Future Operating Results

As a supplier of semiconductors, the Company competes in a challenging business environment, which is characterized by intense competition, rapid technological change and cyclical business patterns. Except for the historical information contained herein, the matters discussed in this report are forward-looking statements. The Company faces a variety of risks and uncertainties in conducting its business, some of which are out of its control, and any of which, were they to occur, could impair the Company's operating performance. For a more detailed discussion of risk factors, please refer to the Company's annual report on Form 10-K for the fiscal year ended February 28, 2003 filed with the Securities and Exchange Commission on May 29, 2003.

ITEM 4. CONTROLS AND PROCEDURES

The Company has carried out an evaluation under the supervision and with the participation of the Company's management, including the Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures. There are inherent limitations to the effectiveness of any system of disclosure controls and procedures, including the possibility of human error and the circumvention or overriding of the controls and procedures. Accordingly, even effective disclosure controls and procedures can only provide reasonable assurance of achieving their control objectives. Based upon the Company's evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that, as of November 30, 2003, the disclosure controls and procedures are effective to provide reasonable assurance that information required to be disclosed in the reports the Company files under the Exchange Act is recorded, processed, summarized and reported as and when required.

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

reporting during the Company's fiscal quarter covered by this report that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II - OTHER INFORMATION

ITEM 1. Legal Proceedings

In June 2003, Standard Microsystems Corporation was named as a defendant in a patent infringement lawsuit filed by Analog Devices, Inc. (ADI) in the United States District Court for the District of Massachusetts (Analog Devices, Inc. v. Standard Microsystems Corporation, Case Number 03 CIV 11216). The Complaint, as amended, alleges that some of the Company's products infringe one or more of three of ADI's patents, and seeks injunctive relief and unspecified damages. In September 2003, the Company filed an Answer in the lawsuit, denying ADI's allegations and raising affirmative defenses and counterclaims. Although it is premature to assess the outcome of the litigation, the Company believes that the allegations against it are without merit.

The Company had been involved in an arbitration with Accton Technology Corporation (Accton) and SMC Networks, Inc. (Networks) related to claims associated with the purchase of an 80.1% interest in Networks by Accton from SMSC in October 1997. This divestiture was accounted for as a discontinued operation, and accordingly, costs associated with this action, net of income taxes, are reported as a Loss from discontinued operations on the Consolidated Statements of Operations. These costs were nominal during the three months ended November 30, 2003, compared to $0.1 million for the three months ended November 30, 2002, after applicable income tax benefits. These costs totaled $0.2 million and $0.5 million in the nine-month periods ended November 30, 2003 and 2002, respectively, after applicable income tax benefits.

In September 2003, the arbitration panel issued its decision in this action, which directed the release of a $2.5 million escrow account to SMSC and awarded certain other payments among the parties.

In December 2003, the parties reached a final settlement of the award, resulting in SMSC receiving $2.7 million in cash and realizing a gain of $0.1 million, after income taxes, which will be reported as a Gain on discontinued operations in the quarter ending February 29, 2004.

ITEM 6. Exhibits and Reports on Form 8-K

(a) Exhibits

31.1 - Certification of Chief Executive Officer pursuant to Rule 13a-14(a) (17 CFR 240.13a-14(a)), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

31.2 - Certification of Chief Financial Officer pursuant to Rule 13a-14(a) (17 CFR 240.13a-14(a)), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

32.1 - Certifications of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

(b) Reports on Form 8-K

On September 25, 2003, SMSC filed a report on Form 8-K relating to its arbitration with Accton Technology Corporation and SMC Networks, Inc.

On September 18, 2003 SMSC filed a report on Form 8-K relating to a press

release issued on September 16, 2003, announcing the Company's second quarter fiscal 2004 operating results.

On September 9, 2003, SMSC filed a report on Form 8-K relating to its September 8, 2003 announcement that Standard Microsystems Corporation and Intel Corporation have enhanced their intellectual property and business relationship.

SIGNATURE

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

STANDARD MICROSYSTEMS CORPORATION

DATE: January 13, 2004

/s/ Andrew M. Caggia

(Signature)

Andrew M. Caggia
Senior Vice President - Finance
(duly authorized officer) and
Chief Financial Officer
(principal financial officer)