

MEMSIC Inc
Form 10-Q
May 13, 2011

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 March 31, 2011

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.)

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

01810
(Zip Code)

(978) 738-0900
(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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during

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the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). 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 \$0.00001 per share, of the registrant outstanding as of May 10, 2011 was 23,825,763.

MEMSIC, Inc.

FORM 10-Q, March 31, 2011

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements (Unaudited)

MEMSIC, Inc.
CONSOLIDATED BALANCE SHEETS
(Unaudited)

	March 31, 2011	December 31, 2010
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 51,272,253	\$ 55,694,205
Restricted cash	2,442,263	2,928,933
Accounts receivable, net of allowance for doubtful accounts of \$6,441	5,446,620	3,664,444
Inventories	10,051,639	8,923,127
Other assets	3,176,061	2,537,445
Total current assets	72,388,836	73,748,154
Property and equipment, net	22,050,619	22,015,502
Long-term investments	4,820,000	5,020,000
Goodwill	4,948,646	4,919,513
Intangible assets, net	11,648,603	11,894,328
Other assets	48,598	67,599
Total assets	\$ 115,905,302	\$ 117,665,096
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 4,824,326	\$ 4,563,420
Accrued expenses	2,176,015	2,969,839
Advance research funding	2,442,263	2,928,933
Total current liabilities	9,442,604	10,462,192
Note payable to bank	17,930,000	17,930,000
Deferred rent	130,604	90,036
Total other liabilities	18,060,604	18,020,036
Stockholders' equity:		
Common stock, \$0.00001 par value; authorized, 45,000,000 shares; 23,813,613 and 23,810,613 shares issued and outstanding at March 31, 2011 and December 31, 2010, respectively	238	238

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Additional paid-in capital	100,022,023	99,615,378
Accumulated other comprehensive income	3,216,075	3,029,372
Accumulated deficit	(15,151,744)	(13,823,565)
MEMSIC, Inc. stockholders' equity	88,086,592	88,821,423
Noncontrolling interest related to joint venture in Japan	315,502	361,445
Total stockholders' equity	88,402,094	89,182,868
Total liabilities and stockholders' equity	\$ 115,905,302	\$ 117,665,096

See notes to consolidated financial statements (unaudited)

MEMSIC, Inc.
CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)

	Three Months Ended March 31,	
	2011	2010
Net sales	\$ 12,954,920	\$ 7,271,993
Cost of goods sold	8,013,199	4,426,499
Gross profit	4,941,721	2,845,494
Operating expenses:		
Research and development	2,297,836	1,973,657
Sales and marketing	1,464,746	1,071,479
General and administrative	2,254,260	1,985,047
Amortization expense	405,935	338,761
Total operating expenses	6,422,777	5,368,944
Operating loss	(1,481,056)	(2,523,450)
Other income:		
Interest and dividend income	83,490	116,664
Foreign exchange gain	190,676	4,021
Other, net	68,576	13,509
Total other income	342,742	134,194
Earnings (loss) before income taxes	(1,138,314)	(2,389,256)
Provision for (benefit from) income taxes	117,394	(116,435)
Net loss	(1,255,708)	(2,272,821)
Less: net income attributable to noncontrolling interest	72,471	47,141
Net loss attributable to MEMSIC, Inc.	\$ (1,328,179)	\$ (2,319,962)
Net loss per common share to MEMSIC, Inc.:		
Basic	\$ (0.06)	\$ (0.10)
Diluted	\$ (0.06)	\$ (0.10)
Weighted average shares outstanding used in calculating net loss per common share:		
Basic	23,811,058	23,797,008
Diluted	23,811,058	23,797,008

See notes to consolidated financial statements (unaudited)

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Cash and cash equivalents —beginning of period		55,694,205		66,970,736
Cash and cash equivalents —end of period	\$	51,272,253	\$	47,763,764

See notes to consolidated financial statements (unaudited)

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 a MEMS technology-based inertial sensor, commonly known as an accelerometer, 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 easy integration of additional functions and 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. The Company's sensor and solution 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) and its indirect wholly owned subsidiary, MEMSIC Transducer Systems Company Limited. (MTS), which are 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 the Company, MEMSIC Semiconductor, MTS and its majority owned and controlled joint venture, Crossbow Japan Limited (Crossbow Japan). The Company presents all of Crossbow Japan's assets, liabilities, revenue and expenses, as well as the non-controlling interest in Crossbow Japan (representing the 49% equity interest in the entity not owned by the Company) in its consolidated financial statements. 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, 2010, 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, 2010, and include all adjustments (consisting of normal, recurring adjustments) necessary for the fair presentation of the Company's financial position at March 31, 2011, results of operations for the three months ended March 31, 2011 and 2010 and cash flows for the three months ended March 31, 2011 and 2010. The interim periods are not necessarily indicative of results to be expected for any other interim periods or for the full year.

Reclassification

Certain amounts in the accompanying 2010 financial statements have been reclassified to permit comparison with the accompanying first quarter of 2011 financial statements.

Use of Estimates

The preparation of financial statements in conformity with U.S. 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.

Advance Research Funding

Advance research funding represents research funding granted by the Chinese government for specific research and development projects the Company is taking on. The amount received is initially recorded as a liability and subsequently recognized as a credit to research and development expenses in the statements of operations as the Company performs the projects and has complied with the conditions or performance obligations attached to the related government grants.

Foreign Currency

The Company's manufacturing operations and certain other operations are conducted by MEMSIC Semiconductor and MTS. The functional currency of MEMSIC Semiconductor and MTS is the Renminbi. Financial transactions between the Company, MEMSIC Semiconductor and MTS are conducted in United States (U.S.) dollars. At March 31, 2011 and December 31, 2010, the underlying currency for approximately 50.2% and 51.1% of consolidated assets, respectively, was the Renminbi. The functional currency of Crossbow Japan is the Japanese Yen. Financial transactions between the Company and Crossbow Japan are conducted in U.S. dollars. At March 31, 2011 and December 31, 2010, the underlying currency for approximately 1.1% of consolidated assets was the Japanese Yen. The Company does not believe that it is subject to significant foreign exchange risk and, accordingly, has not utilized hedging strategies with respect to its foreign exchange exposure.

The financial statements of MEMSIC Semiconductor, MTS and Crossbow Japan are translated into U.S. dollars in accordance with U.S. GAAP. The functional currencies of MEMSIC Semiconductor, MTS and Crossbow Japan are 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, accounts receivable, accounts payable, notes payable and accrued expenses, approximate their fair values due to the short-term nature of

the instruments.

Net Loss per Common Share

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

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. At March 31, 2011 and December 31, 2010, the Company's total inventory reserve balances were \$498,000 and \$482,000, respectively.

Revenue Recognition

The Company recognizes revenue from the sale of its products 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 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.

Stock-Based Compensation

The Company accounts for share-based payments to employees based on requirements that all share-based payments to employees, including grants of employee stock options, shall be recognized in the financial statements based on their fair values. The cost of equity-based service awards is based on the grant-date fair value of the award and is recognized over the period during which the employee is required to provide service in exchange for the award (vesting period). 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 October 2009, the FASB issued ASU No. 2009-13, Revenue Recognition (Topic 605) — Multiple-Deliverable Revenue Arrangements. ASU No. 2009-13 addresses the accounting for multiple-deliverable arrangements to enable vendors to account for products or services (deliverables) separately rather than as a combined unit. This guidance establishes a selling price hierarchy for determining the selling price of a deliverable, which is based on:

(a) vendor-specific objective evidence; (b) third-party evidence; or (c) estimates. This guidance also eliminates the residual method of allocation and requires that arrangement consideration be allocated at the inception of the arrangement to all deliverables using the relative selling price method. In addition, this guidance significantly expands required disclosures related to a vendor's multiple-deliverable revenue arrangements. ASU No. 2009-13 is effective prospectively for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010 and early adoption is permitted. A company may elect, but will not be required, to adopt the amendments in ASU No. 2009-13 retrospectively for all prior periods. The adoption of ASU 2009-13 did not have a material impact on the Company's financial position or statement of operations.

3. LONG-TERM INVESTMENTS

Investments held by the Company at March 31, 2011 and December 31, 2010 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 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 are included in interest and dividend income. Quarterly, management reviews the valuation of investments and considers whether any decline in value is deemed to be other than a temporary decline.

At March 31, 2011, the Company held two ARS investments: Illinois Educational Facilities Authority Select Auction Variable Rate Securities having a value at par of \$3.0 million with a maturity date in 2028 and Montana Health Facility Authority Select Auction Variable Rate Securities having a value at par of \$2.2 million with a maturity date in 2017. The Company has classified these investments as long-term assets due to liquidity issues that have been experienced in global credit and capital markets as well as failed auctions since the first quarter of 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 accounts for assets and liabilities recognized or disclosed in the financial statements at fair value on a recurring basis in accordance with the provisions of ASC Topic 820.

ASC Topic 820 provides 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. ASC Topic 820 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

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 March 31, 2011	Level 1	Level 2	Level 3	Valuation Technique
Auction rate securities	\$4,820	\$-	\$-	\$4,820	(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 Securities
Balance at January 1, 2011	\$ 5,020
Redemptions	(200)
Transfers to Level 3	-
Gains and losses:	
Reported in earnings	-
Reported in other comprehensive loss	-
Balance at March 31, 2011	\$ 4,820

The Company historically accounted 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 at the specified contractual rate on those investments involved in failed auctions, due to 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 March 31, 2011 and December 31, 2011. The Company estimated the fair value of these securities at March 31, 2011 and December 31, 2010 using broker valuations and internally-developed models of the expected future cash flows related to the securities as well as referencing a third party specialist's valuation. 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 and the discount related to the illiquidity of the investments. The Company developed several scenarios for the liquidation of the auction rate securities over periods that ranged from 3 to 7 years. In estimating the fair value of these investments, the Company considered the financial condition and near-term prospects 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. Based on its estimated operating cash flows and other sources of cash, the Company intends to hold these auction rate securities for the foreseeable future, if necessary.

The Company's valuation analysis in the first quarter of 2011 resulted in no change to the unrealized impairment loss on record at December 31, 2010. As of March 31, 2011, the unrealized impairment loss is \$400,000. The Company continues to monitor the market for auction rate securities and to assess its impact 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 loss 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:

	March 31, 2011	December 31, 2010
Raw materials	\$ 4,505,477	\$ 3,583,679
Work in process	3,886,662	3,276,095
Finished units	1,659,500	2,063,353
Total	\$ 10,051,639	\$ 8,923,127

5. GOODWILL AND INTANGIBLE ASSETS

Goodwill

Goodwill represents the excess cost of the Crossbow asset acquisition over the net fair value allocated to the assets acquired and liabilities assumed and to the acquired intangible asset that does not qualify for separate recognition according to ASC 805. The Company reported goodwill of \$4,948,646 at March 31, 2011.

The Company performed an annual impairment test for goodwill during the fourth quarter of 2010 and concluded that no impairment existed as of December 31, 2010. It is the Company's opinion that there has been no change in circumstances that would indicate a potential impairment as of March 31, 2011. The Company will continue to perform an annual impairment test for goodwill during the fourth quarter of each fiscal year, and more frequently if an event or circumstances indicate that an impairment loss has been incurred. Conditions that would trigger an impairment assessment include, but are not limited to, a significant adverse change in legal factors or business climate that could affect the value of an asset.

Intangible Assets

Intangible assets relate to issued and applied-for patents on the Company's core technology and gas meter processing know-how purchased in May 2008, as well as trademarks, customer relationships and developed technology acquired from Crossbow Technology, Inc. on January 15, 2010.

As of March 31, 2011, intangible assets consisted of the following:

	Gross carrying amount	Accumulated amortization	Net carrying amount	Expected life (Years)
Patents	\$ 1,089,310	\$ (225,979)	\$ 863,331	15
Know-how	536,740	(303,999)	232,741	5
Trademarks	396,730	(239,691)	157,039	2
Customer relationships	4,655,059	(615,168)	4,039,891	8-10
Developed technology	7,251,810	(896,209)	6,355,601	8-10
	\$ 13,929,649	\$ (2,281,046)	\$ 11,648,603	

Amortization expense expected over the next five years is approximately \$1.4 million per year. Amortization expense amounted to \$406,000 and \$339,000, respectively for the three months ended March 31, 2011 and 2010.

The Company has considered the cash flows associated with the valuation of the definite-lived intangible assets and concluded that the straight line method best approximates the economic pattern of usefulness of those assets.

6. NOTE PAYABLE TO BANK

On June 30, 2010, MTS, a wholly owned subsidiary of MEMSIC Semiconductor, entered into a five-year project loan agreement with Agricultural Bank of China. The total loan available is \$20 million, of which \$15 million was used by the Company for the purchase of substantially all the assets acquired from Crossbow Technology, Inc., \$3 million for working capital purposes and \$2 million for the purchase of equipment to be used in the manufacture of the Company's system solution products.

The loan is collateralized by the buildings and land owned by MEMSIC Semiconductor as well as the land and intellectual property owned by MTS. The interest rate of the loan is a variable rate, adjusted semi-annually based on the LIBOR rate plus 4.00%. MTS has obtained agreement from the local government in Wuxi, China to fully subsidize the interest expense on a quarterly basis. There's no other financial covenant required for this loan. As of March 31, 2011, MTS has withdrawn an amount of \$17.9 million and has \$2.1 million available for borrowing. Interest expense paid and subsidized by the Wuxi government for the three months ended March 31, 2011 was \$0.2 million. In the remote event the Wuxi government is unable to fulfill its obligation, the Company would recognize the interest expense in its income statement. The repayment schedule of the principal amount is as follows:

Date	Payment Amount
June 29, 2012	\$ 500,000
June 29, 2013	\$ 1,000,000
	\$ 2,500,000

June 29, 2014	
June 29, 2015	\$ 13,930,000
	\$ 17,930,000

7. 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. With the adoption of the 2007 Plan discussed below, the Company no longer grants awards under the 2000 Plan.

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.

Options granted under the 2000 Plan and the 2007 Plan may be incentive stock options, nonqualified stock options and/or restricted stocks. Both the 2000 Plan and the 2007 Plan provide 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.

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.

On December 9, 2009, the Company's board of directors approved the 2009 Nonqualified Inducement Stock Option Plan (the "2009 Plan") with an effective date on January 15, 2010, the acquisition closing date. Under the 2009 Plan, up to 1,250,000 shares of the Company's common stock may become available for issuance. On December 23, 2010, the Company's board of directors approved an Amended and Restated 2009 Nonqualified Inducement Stock Option Plan (the "Amended and Restated Plan") and an increase in shares of the Company's common stock available for issuance under the Amended and Restated Plan from 1,250,000 to 2,500,000. Except as otherwise determined by the Compensation Committee of the Company's board of directors, the form of option to be employed under the Amended and Restated Plan shall be substantially identical to the form of nonqualified option customarily used under the Company's 2007 Stock Incentive Plan.

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 months ended March 31, 2011 and 2010 were \$1.81 and \$2.14, respectively, utilizing the following assumptions:

	Three Months Ended	
	March 31,	
	2011	2010
Volatility	64%	

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		69% - 70%
Expected dividend yield	0%	0%
Expected life	5.8 years	5.8-6.0 years
Risk free interest rate	2.34%	2.40%
Forfeitures	38%	36-37%

The Company is responsible for estimating volatility and has considered a number of factors, including analysis of volatility data for a peer group of companies. The Company determined the volatility for options granted in the three months ended March 31, 2011 based on the historical volatility of the Company's common stock, which the Company believes results in the best estimate of the grant-date fair value of employee stock options because it reflects the market's current expectations of future volatility. Prior to January 1, 2010, due to limited historical information on the volatility of the Company's common stock, the Company determined the volatility for options 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 was 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 ASC Topic 718, Compensation – Stock Compensation. The Company uses historical employee exercise and option expiration data to estimate the expected life assumption for the Black-Scholes grant-date valuation. The Company believes that this historical data is currently the best estimate of the expected term of a new option, and generally its employees exhibit similar exercise behavior.

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. The Company applies an estimated forfeiture rate, based on its historical forfeiture experience, in determining the expense recorded in the Company's consolidated statement of operations.

For the three months ended March 31, 2011 and 2010, the Company recorded stock-based compensation expense of \$401,415 and \$383,489, respectively. Stock-based compensation expense related to stock options for the three months ended March 31, 2011 and 2010 was allocated as follows:

	Three Months Ended March 31,	
	2011	2010
Research and development	\$ 121,194	\$ 38,857
Sales and marketing	66,015	44,773
General and administrative	214,206	299,859
Total	\$ 401,415	\$ 383,489

The Company has historically accounted for stock options granted to consultants using the fair value method for the calculation of compensation cost. For the three months ended March 31, 2011 and 2010, the Company recorded compensation expense for stock option grants to consultants in the amount of \$10,700 and \$0, respectively.

At March 31, 2011, total unrecognized stock-based compensation expense for stock options granted to the Company's employees and directors was estimated to approximate \$2.8 million. The total unrecognized stock-based compensation expense related to the non-qualified common stock option grants to consultants expected to be charged to operations was estimated to approximate \$10,700 at March 31, 2011.

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The stock option activity under the 2000, 2007 and 2009 Plan for the three months ended March 31, 2011 is as follows:

	Options Outstanding	Weighted Average Exercise Price	Remaining Contractual Term in Years	Aggregate Intrinsic Value
Options outstanding at December 31, 2010	2,588,080	\$4.76	7.4	\$1,863,883
Granted	5,000	3.06		