US BANCORP \DE\
Form 10-Q
August 09, 2006

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**UNITED STATES**
**SECURITIES AND EXCHANGE COMMISSION**
**Washington, D.C. 20549**

**FORM 10-Q**
**þ QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
**For the quarterly period ended June 30, 2006**
**OR**
**o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
**For the transition period from (not applicable)**
**Commission File Number 1-6880**
**U.S. BANCORP**
(Exact name of registrant as specified in its charter)

| | |
|---|---|
| **Delaware** | **41-0255900** |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |

**800 Nicollet Mall**
**Minneapolis, Minnesota 55402**
(Address of principal executive offices, including zip code)
**651-466-3000**
(Registrant s telephone number, including area code)
**(not applicable)**
(Former name, former address and former fiscal year, if changed since last report)

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, and (2) has been subject to such filing requirements for the past 90 days.

YES þ NO o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer þ Accelerated filer o Non-accelerated filer o

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

YES o NO þ

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date.

| Class | Outstanding as of July 31, 2006 |
|---|---|
| Common Stock, $.01 Par Value | 1,777,189,374 shares |

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Computation of Ratio of Earnings to Fixed Charges
Certification of Chief Executive Officer to Rule 13a-14(a)
Certification of Chief Financial Officer to Rule 13a-14(a)
Certification of CEO and CFO pursuant to 18 U.S.C. Section 1350


**Safe Harbor Statement under the Private Securities Litigation Reform Act of 1995.**

This Form 10-Q contains forward-looking statements about U.S. Bancorp. Statements that are not historical or current facts, including statements about beliefs and expectations, are forward-looking statements. These statements often include the words may, could, would, should, believes, expects, anticipates, estimates, intends, potentially, probably, projects, outlook or similar expressions. These forward-looking statements cover, among oth things, anticipated future revenue and expenses and the future plans and prospects of the Company. Forward-looking statements involve inherent risks and uncertainties, and important factors could cause actual results to differ materially from those anticipated, including changes in general business and economic conditions, changes in interest rates, legal and regulatory developments, increased competition from both banks and non-banks, changes in customer behavior and preferences, effects of mergers and acquisitions and related integration, and effects of critical accounting policies and judgments. For discussion of these and other risks that may cause actual results to differ from expectations, refer to our Annual Report on Form 10-K for the year ended December 31, 2005, on file with the Securities and Exchange Commission, including the sections entitled Risk Factors and Corporate Risk Profile. Forward-looking statements speak only as of the date they are made, and the Company undertakes no obligation to update them in light of new information or future events.

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**Table 1** Selected Financial Data

| (Dollars and Shares in Millions, Except Per Share Data) | Three Months Ended June 30, 2006 | 2005 | Percent Change | Six Months Ended June 30, 2006 | 2005 | Percent Change |
|---|---|---|---|---|---|---|
| **Condensed Income Statement** | | | | | | |
| Net interest income (taxable-equivalent basis) (a) | $1,697 | $1,761 | (3.6)% | $3,422 | $3,512 | (2.6)% |
| Noninterest income | 1,752 | 1,540 | 13.8 | 3,366 | 2,981 | 12.9 |
| Securities gains (losses), net | 3 | 1 | * | 3 | (58) | * |
| Total net revenue | 3,452 | 3,302 | 4.5 | 6,791 | 6,435 | 5.5 |
| Noninterest expense | 1,530 | 1,595 | (4.1) | 3,030 | 2,926 | 3.6 |
| Provision for credit losses | 125 | 144 | (13.2) | 240 | 316 | (24.1) |
| Income before taxes | 1,797 | 1,563 | 15.0 | 3,521 | 3,193 | 10.3 |
| Taxable-equivalent adjustment | 11 | 7 | 57.1 | 21 | 14 | 50.0 |
| Applicable income taxes | 585 | 435 | 34.5 | 1,146 | 987 | 16.1 |
| Net income | $1,201 | $1,121 | 7.1 | $2,354 | $2,192 | 7.4 |
| Net income applicable to common equity | $1,184 | $1,121 | 5.6 | $2,337 | $2,192 | 6.6 |
| **Per Common Share** | | | | | | |
| Earnings per share | $.66 | $.61 | 8.2% | $1.30 | $1.19 | 9.2% |
| Diluted earnings per share | .66 | .60 | 10.0 | 1.29 | 1.17 | 10.3 |
| Dividends declared per share | .33 | .30 | 10.0 | .66 | .60 | 10.0 |
| Book value per share | 10.89 | 10.88 | .1 | | | |
| Market value per share | 30.88 | 29.20 | 5.8 | | | |
| Average common shares outstanding | 1,781 | 1,833 | (2.8) | 1,791 | 1,842 | (2.8) |
| Average diluted common shares outstanding | 1,805 | 1,857 | (2.8) | 1,816 | 1,869 | (2.8) |
| **Financial Ratios** | | | | | | |
| Return on average assets | 2.27% | 2.23% | | 2.25% | 2.22% | |
| Return on average common equity | 24.3 | 22.7 | | 23.8 | 22.3 | |
| Net interest margin (taxable-equivalent basis) | 3.68 | 3.99 | | 3.74 | 4.03 | |
| Efficiency ratio (b) | 44.4 | 48.3 | | 44.6 | 45.1 | |
| **Average Balances** | | | | | | |

| | | | | | | |
|---|---|---|---|---|---|---|
| Loans | $140,863 | $131,275 | 7.3% | $140,125 | $129,474 | 8.2% |
| Loans held for sale | 2,062 | 1,697 | 21.5 | 1,866 | 1,564 | 19.3 |
| Investment securities | 40,087 | 42,341 | (5.3) | 39,885 | 42,576 | (6.3) |
| Earning assets | 184,890 | 176,730 | 4.6 | 184,000 | 175,022 | 5.1 |
| Assets | 212,407 | 201,818 | 5.2 | 211,222 | 199,390 | 5.9 |
| Noninterest-bearing deposits | 28,949 | 29,148 | (.7) | 28,893 | 28,784 | .4 |
| Deposits | 121,233 | 121,232 | | 120,701 | 120,332 | .3 |
| Short-term borrowings | 22,246 | 17,013 | 30.8 | 23,295 | 16,313 | 42.8 |
| Long-term debt | 41,225 | 36,973 | 11.5 | 39,735 | 36,211 | 9.7 |
| Shareholders equity | 20,556 | 19,820 | 3.7 | 20,353 | 19,812 | 2.7 |

| | June 30, 2006 | December 31, 2005 | |
|---|---|---|---|
| **Period End Balances** | | | |
| Loans | $141,382 | $137,806 | 2.6% |
| Allowance for credit losses | 2,251 | 2,251 | |
| Investment securities | 38,462 | 39,768 | (3.3) |
| Assets | 213,405 | 209,465 | 1.9 |
| Deposits | 122,719 | 124,709 | (1.6) |
| Long-term debt | 41,952 | 37,069 | 13.2 |
| Shareholders equity | 20,415 | 20,086 | 1.6 |
| Regulatory capital ratios | | | |
| Tier 1 capital | 8.9% | 8.2% | |
| Total risk-based capital | 13.1 | 12.5 | |
| Leverage | 8.2 | 7.6 | |
| Tangible common equity | 5.6 | 5.9 | |

* *Not meaningful.*

(a) *Interest and rates are presented on a fully taxable-equivalent basis utilizing a tax rate of 35 percent.*

(b) *Computed as noninterest expense divided by the sum of net interest income on a taxable-equivalent basis and noninterest income excluding securities gains (losses), net.*

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Management s Discussion and Analysis

**OVERVIEW**

**Earnings Summary** U.S. Bancorp and its subsidiaries (the Company ) reported net income of $1,201 million for the second quarter of 2006, compared with $1,121 million for the second quarter of 2005. Net income of $.66 per diluted common share in the second quarter of 2006 was higher than the same period of 2005 by $.06 (10.0 percent). Return on average assets and return on average common equity were 2.27 percent and 24.3 percent, respectively, for the second quarter of 2006, compared with returns of 2.23 percent and 22.7 percent, respectively, for the second quarter of 2005. The Company s results for the second quarter of 2006 improved over the same period of 2005, as net income increased by $80 million (7.1 percent), primarily due to strong growth in a majority of fee-based products.

Total net revenue, on a taxable-equivalent basis, for the second quarter of 2006, was $150 million (4.5 percent) higher than the second quarter of 2005, primarily reflecting a 13.9 percent increase in noninterest income, partially offset by a 3.6 percent decline in net interest income reflecting the impact of rising interest rates during the past several quarters. Noninterest income growth was driven by organic business growth and recent expansion in trust and payment processing businesses. Noninterest income also included a gain related to the initial public offering of a cardholder association. These favorable changes in noninterest income were partially offset by lower mortgage banking revenue due to the impact of adopting the fair value method of accounting under Statement of Financial Accounting Standards No. 156 Accounting for Servicing of Financial Assets ( SFAS 156 ) in the first quarter of 2006. Mortgage banking revenue in the second quarter of 2006 included the effect of principal repayments on the valuation of servicing rights that were previously recognized as part of intangible expense.

Total noninterest expense in the second quarter of 2006 was $65 million (4.1 percent) lower than the second quarter of 2005, primarily reflecting lower intangible expense due to the adoption of SFAS 156 and lower debt prepayment expense. This was partially offset by incremental operating and business integration costs principally associated with recent acquisitions, increased pension costs and higher expenses related to investments in tax-advantaged projects from a year ago. The efficiency ratio (the ratio of noninterest expense to taxable-equivalent net revenue excluding net securities gains or losses) was 44.4 percent for the second quarter of 2006, compared with 48.3 percent for the second quarter of 2005.

The provision for credit losses for the second quarter of 2006 decreased $19 million (13.2 percent), compared with the second quarter of 2005. The decrease in the provision for credit losses year-over-year primarily reflected strong credit quality and the near-term favorable impact of changes in bankruptcy law in the fourth quarter of 2005. Net charge-offs in the second quarter of 2006 were $125 million, compared with $144 million in the second quarter of 2005. The decline in credit losses from a year ago was principally due to the impact of changes in bankruptcy legislation that went into effect during the fourth quarter of 2005. Refer to Corporate Risk Profile for further information on the provision for credit losses, net charge-offs, nonperforming assets and factors considered by the Company in assessing the credit quality of the loan portfolio and establishing the allowance for credit losses.

The Company reported net income of $2,354 million for the first six months of 2006, compared with $2,192 million for the first six months of 2005. Net income of $1.29 per diluted common share in the first six months of 2006 was higher than the same period of 2005 by $.12 (10.3 percent). Return on average assets and return on average common equity were 2.25 percent and 23.8 percent, respectively, for the first six months of 2006, compared with returns of 2.22 percent and 22.3 percent, respectively, for the first six months of 2005. The Company s results for the first six months of 2006 improved over the same period of 2005, as net income rose by $162 million (7.4 percent), primarily due to strong revenue growth in fee-based products.

Total net revenue, on a taxable-equivalent basis, for the first six months of 2006, was $356 million (5.5 percent) higher than the first six months of 2005, primarily reflecting a 15.3 percent increase in noninterest income, partially offset by a 2.6 percent decline in net interest income, reflecting the impact of rising interest rates during the past several quarters. Noninterest income growth was driven by organic business growth, recent expansion in trust and payment processing businesses, trading income related to certain derivatives, a favorable settlement during the first quarter of 2006 and the gain from the initial public offering of a cardholder association during the second quarter of 2006. These favorable changes in noninterest

income categories were partially offset by lower mortgage banking revenue due to the impact of adopting SFAS 156 in the first quarter of 2006. In addition, there was a $61 million favorable variance in net securities gains (losses) in the first six months of 2006 as compared with the same period of 2005.

Total noninterest expense in the first six months of 2006 was $104 million (3.6 percent) higher than the first six months of 2005, primarily reflecting incremental operating and business integration costs principally associated with recent acquisitions, increased pension costs and higher expenses related to investments in tax-advantaged projects from a year ago. This was partially offset by lower intangible expense due to the adoption of SFAS 156 and lower debt prepayment expense. The efficiency ratio was 44.6 percent for the first six months of 2006, compared with 45.1 percent for the first six months of 2005.

The provision for credit losses for the first six months of 2006 decreased $76 million (24.1 percent), compared with the first six months of 2005. The decrease in the provision for credit losses year-over-year primarily reflected strong credit quality and the near-term favorable impact of changes in bankruptcy law in the fourth quarter of 2005. Net charge-offs in the first six months of 2006 were $240 million, compared with $316 million in the first six months of 2005. The decline in losses from a year ago was principally due to the impact of changes in bankruptcy legislation that went into effect during the fourth quarter of 2005. Refer to Corporate Risk Profile for further information on the provision for credit losses, net charge-offs, nonperforming assets and factors considered by the Company in assessing the credit quality of the loan portfolio and establishing the allowance for credit losses.

**STATEMENT OF INCOME ANALYSIS**

**Net Interest Income** Net interest income, on a taxable-equivalent basis, was $1,697 million in the second quarter of 2006, compared with $1,761 million in the second quarter of 2005. Net interest income, on a taxable-equivalent basis, was $3,422 million in the first six months of 2006, compared with $3,512 million in the first six months of 2005. Average earning assets increased $8.2 billion (4.6 percent) and $9.0 billion (5.1 percent) in the second quarter and first six months of 2006, respectively, compared with the same periods of 2005. The increases were primarily driven by growth in residential mortgages, commercial loans, retail loans and commercial real estate loans, partially offset by a decrease in investment securities. The positive impact to net interest income from the growth in earning assets was more than offset by a lower net interest margin. The net interest margin for the second quarter and first six months of 2006 was 3.68 percent and 3.74 percent, respectively, compared with 3.99 percent and 4.03 percent, respectively, for the same periods of 2005. The year-over-year decline in the net interest margin for the second quarter and first six months of 2006 reflected the competitive lending environment during 2005 and the first half of 2006, asset/liability management decisions and the impact of changes in the yield curve from a year ago. Compared with the same periods of 2005, credit spreads have tightened by approximately 23 basis points in the second quarter and 21 basis points in the first six months of 2006 across most lending products due to competitive pricing and a change in mix due to growth in lower-spread, fixed-rate credit products. The net interest margin also declined due to funding incremental asset growth with higher cost wholesale funding, share repurchases and asset/liability decisions designed to reduce the Company s interest rate sensitivity position. An increase in the margin benefit of net free funds and loan fees partially offset these factors. Refer to the Consolidated Daily Average Balance Sheet and Related Yields and Rates table for further information on net interest income.

Average loans for the second quarter and first six months of 2006 were higher by $9.6 billion (7.3 percent) and $10.7 billion (8.2 percent), respectively, compared with the same periods of 2005, reflecting growth in the majority of loan categories. During the first quarter of 2006, the Company began selling an increased proportion of its residential mortgage loan production and anticipates that residential mortgage loan balances will remain essentially flat in future periods.

Average investment securities in the second quarter and first six months of 2006 were $2.3 billion (5.3 percent) and $2.7 billion (6.3 percent) lower, respectively, than the same periods of 2005. The change in the balance of the investment securities portfolio from a year ago principally reflected asset/liability management decisions to reduce the focus on residential mortgage assets given the changing interest rate environment and mix of loan growth. Additionally, the Company reclassified approximately $460 million of principal-only securities to its trading account effective January 1, 2006, in connection with the adoption of SFAS 156. During the second quarter and first six months of 2006, the Company maintained a mix of approximately 40 percent variable-rate securities. Refer to the

Interest Rate Risk Management section for further information on the sensitivity of net interest income to changes in interest rates.

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Average noninterest-bearing deposits for the second quarter and first six months of 2006 remained relatively flat compared with the same periods of the prior year. The average balances for the second quarter and first six months of 2006 decreased $199 million (.7 percent) and increased $109 million (.4 percent), respectively, compared with the same periods of 2005, despite a reduction of excess liquidity in the markets.

Average total savings products declined year-over-year by $2.4 billion (4.2 percent) in the second quarter and $2.8 billion (4.8 percent) in the first six months of 2006, compared with the same periods of 2005, due to reductions in average money market savings and other savings account balances. Average money market savings balances declined year-over-year primarily due to a decline in balances within the branches. This decrease was partially offset by increases in broker dealer and corporate trust balances. The overall decrease in average money market savings balances year-over-year was primarily the result of the Company s deposit pricing decisions for money market products in relation to fixed-rate deposit products offered. As a result, a portion of branch-based money market savings accounts have migrated to fixed-rate time certificates, while larger customer money market savings accounts have migrated to time deposits greater than $100,000 as rates increased on the time deposit products.

Average time certificates of deposit less than $100,000 were higher by $537 million (4.1 percent) and $532 million (4.1 percent) in the second quarter and first six months of 2006, respectively, compared with the same periods of 2005. Average time deposits greater than $100,000 grew $2.1 billion (10.3 percent) and $2.5 billion (12.9 percent) in the second quarter and first six months of 2006, respectively, compared with the same periods of 2005. This growth was broad-based across most areas of the Company including: corporate, commercial, branch banking, private client and corporate trust, as customers migrated balances to higher rate deposits.

**Provision for Credit Losses** The provision for credit losses for the second quarter and first six months of 2006 decreased $19 million (13.2 percent) and $76 million (24.1 percent), respectively, compared with the same periods of 2005. The decrease in the provision for credit losses year-over-year primarily reflected stronger credit quality and the near-term favorable impact of changes in bankruptcy law in the fourth quarter of 2005. Net charge-offs in the second quarter and first six months of 2006 were $125 million and $240 million, respectively, compared with $144 million and $316 million in the second quarter and first six months of 2005, respectively. The decline in losses from a year ago was principally due to the impact of changes in bankruptcy legislation that went into effect during the fourth quarter of 2005. Refer to Corporate Risk Profile for further information on the provision for credit losses, net charge-offs, nonperforming assets and factors considered by the Company in assessing the credit quality of the loan portfolio and establishing the allowance for credit losses.

**Noninterest Income** Noninterest income in the second quarter and first six months of 2006 was $1,755 million and $3,369 million, respectively, compared with $1,541 million and $2,923 million in the same periods of 2005. The $214 million (13.9 percent) increase during the second quarter and $446 million (15.3 percent) increase during the first six months of 2006, compared with the same periods in

**Table 2** Noninterest Income

| (Dollars in Millions) | Three Months Ended June 30, 2006 | 2005 | Percent Change | Six Months Ended June 30, 2006 | 2005 | Percent Change |
|---|---|---|---|---|---|---|
| Credit and debit card revenue | $202 | $177 | 14.1% | $384 | $331 | 16.0% |
| Corporate payment products revenue | 139 | 120 | 15.8 | 266 | 227 | 17.2 |
| ATM processing services | 61 | 57 | 7.0 | 120 | 104 | 15.4 |
| Merchant processing services | 253 | 198 | 27.8 | 466 | 376 | 23.9 |
| Trust and investment management fees | 314 | 253 | 24.1 | 611 | 500 | 22.2 |
| Deposit service charges | 264 | 234 | 12.8 | 496 | 444 | 11.7 |
| Treasury management fees | 116 | 117 | (.9) | 223 | 224 | (.4) |

| | | | | | | |
|---|---|---|---|---|---|---|
| Commercial products revenue | 107 | 100 | 7.0 | 211 | 196 | 7.7 |
| Mortgage banking revenue | 75 | 110 | (31.8) | 99 | 212 | (53.3) |
| Investment products fees and commissions | 42 | 39 | 7.7 | 80 | 78 | 2.6 |
| Securities gains (losses), net | 3 | 1 | * | 3 | (58) | * |
| Other | 179 | 135 | 32.6 | 410 | 289 | 41.9 |
| Total noninterest income | $ 1,755 | $ 1,541 | 13.9% | $ 3,369 | $ 2,923 | 15.3% |

* *Not meaningful*

2005, were driven by favorable variances in the majority of fee income categories and a $35 million gain from the initial public offering of a cardholder association included in other income. The increase in noninterest income for the first six months of 2006 also reflected the impact of additional trading income related to certain derivatives recorded in the current year and a favorable variance in securities gains (losses) of $61 million related to net securities losses recorded in the prior year. This strong growth in revenue was partially offset by the accounting impact of SFAS 156 on mortgage banking revenue.

The growth in credit and debit card revenue was primarily driven by higher customer transaction volumes. The corporate payment products revenue growth reflected organic growth in sales volumes and card usage. ATM processing services revenue for the first six months of 2006 was higher due to the acquisition of an ATM business in May of 2005. Merchant processing services revenue growth reflects an increase in sales volume driven by acquisitions, higher same store sales and equipment fees. Trust and investment management fees increased in the second quarter and first six months year-over-year, primarily due to improved equity market conditions, incremental account growth and customer balances and the acquisition of the corporate and institutional trust business of a large national bank. Deposit service charges grew year-over-year due to increased transaction-related fees and growth in net checking accounts. Other income for the second quarter and first six months of 2006 was higher than the same periods of 2005 due to a $35 million gain from the initial public offering of a cardholder association. In addition, other income for the first six months of 2006 was higher due to a $44 million gain on certain interest rate swaps, end-of-term lease residual value improvement, higher student loan sales gains and the receipt of a favorable settlement within the merchant processing business. These favorable changes in fee-based revenue were partially offset by the decline in mortgage banking revenue, principally driven by the adoption of the fair value method of accounting for mortgage servicing rights ( MSR ) under SFAS 156.

**Noninterest Expense** Noninterest expense was $1,530 million and $3,030 million, respectively, in the second quarter and first six months of 2006, a decrease of $65 million (4.1 percent) and an increase of $104 million (3.6 percent), respectively, from the same periods of 2005. The decrease in expense in the second quarter of 2006, compared with the second quarter of 2005, reflected the impact of adopting SFAS 156 on other intangible expense and lower debt prepayment expense. The increase in expense in the first six months of 2006, compared with the same period of the prior year, reflected the impact of business acquisitions and related integration costs, partially offset by lower other intangible and debt prepayment expense. Compensation expense was higher year-over-year in the second quarter and first six months of 2006, primarily due to business expansion, including the Company s payment processing businesses, the acquisition of a large national bank s corporate and institutional trust business and other growth initiatives. Employee benefits increased year-over-year primarily as a result of higher pension costs. Net occupancy and equipment expense increased in the first six months of 2006 from the same period of 2005 primarily due to business expansion. Technology and communications expense rose due to increased software expense and higher outside data processing expense principally associated with expanding a prepaid gift card program and the acquisition of a large national

**Table 3** Noninterest Expense

| | Three Months Ended June 30, | | | Six Months Ended June 30, | | |
|---|---|---|---|---|---|---|
| (Dollars in Millions) | 2006 | 2005 | Percent Change | 2006 | 2005 | Percent Change |
| Compensation | $627 | $612 | 2.5% | $1,260 | $1,179 | 6.9% |
| Employee benefits | 123 | 108 | 13.9 | 256 | 224 | 14.3 |
| Net occupancy and equipment | 161 | 159 | 1.3 | 326 | 313 | 4.2 |
| Professional services | 41 | 39 | 5.1 | 76 | 75 | 1.3 |
| Marketing and business development | 58 | 67 | (13.4) | 98 | 110 | (10.9) |

| | | | | | | |
|---|---|---|---|---|---|---|
| Technology and communications | 127 | 113 | 12.4 | 244 | 219 | 11.4 |
| Postage, printing and supplies | 66 | 63 | 4.8 | 132 | 126 | 4.8 |
| Other intangibles | 89 | 181 | (50.8) | 174 | 252 | (31.0) |
| Debt prepayment | 11 | 54 | (79.6) | 11 | 54 | (79.6) |
| Other | 227 | 199 | 14.1 | 453 | 374 | 21.1 |
| Total noninterest expense | $1,530 | $1,595 | (4.1)% | $3,030 | $2,926 | 3.6% |
| Efficiency ratio (a) | 44.4% | 48.3% | | 44.6% | 45.1% | |

*(a) Computed as noninterest expense divided by the sum of net interest income on a taxable-equivalent basis and noninterest income excluding securities gains (losses), net.*

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bank s corporate and institutional trust business. Other expense increased in the second quarter and first six months of 2006 from the same periods of 2005, primarily due to the increased investments in tax-advantaged projects relative to a year ago and business integration costs. These expense increases were offset by a year-over-year decline in other intangibles expense, reflecting the elimination of MSR amortization and impairment due to the adoption of SFAS 156, and lower debt prepayment expense.

**Income Tax Expense** The provision for income taxes was $585 million (an effective rate of 32.8 percent) for the second quarter and $1,146 million (an effective rate of 32.7 percent) for the first six months of 2006, compared with $435 million (an effective rate of 28.0 percent) and $987 million (an effective rate of 31.0 percent) for the same periods of 2005. The second quarter of 2005 included a $94 million reduction in income tax expense related to the resolution of federal income tax examinations covering substantially all of the Company s legal entities for the years 2000 through 2002. For further information on income taxes, refer to Note 9 of the Notes to Consolidated Financial Statements.

## BALANCE SHEET ANALYSIS

**Loans** The Company s total loan portfolio was $141.4 billion at June 30, 2006, compared with $137.8 billion at December 31, 2005, an increase of $3.6 billion (2.6 percent). The increase in total loans was driven primarily by growth in commercial loans, residential mortgages and retail loans. The $2.4 billion (5.7 percent) increase in commercial loans was primarily driven by new customer relationships, utilization under lines of credit, growth in commercial leasing and corporate payment card balances.

Commercial real estate loans were $28.6 billion at June 30, 2006, an increase of $.1 billion (.3 percent) compared with December 31, 2005. The increase was driven by growth in construction loans, partially offset by a decrease in commercial mortgage balances.

Residential mortgages held in the loan portfolio were $21.1 billion at June 30, 2006, an increase of $.3 billion (1.6 percent) compared with December 31, 2005. The growth was the result of an increase in consumer finance originations, partially offset by the Company selling an increased proportion of its residential mortgage loan production in 2006.

Total retail loans outstanding, which include credit card, retail leasing, home equity and second mortgages and other retail loans, increased $.7 billion (1.6 percent) at June 30, 2006, compared with December 31, 2005. The increase was primarily driven by growth in installment, credit card and home equity loans, partially offset by decreases in retail leasing, home equity lines and student loan balances.

**Investment Securities** Investment securities, both available-for-sale and held-to-maturity, totaled $38.5 billion at June 30, 2006, compared with $39.8 billion at December 31, 2005, reflecting purchases of $3.7 billion of securities, which were more than offset by maturities and prepayments and the reclassification of $.5 billion of principal-only securities to the trading account effective January 1, 2006, in connection with the adoption of SFAS 156. As of June 30, 2006, approximately 40 percent of the investment securities portfolio represented adjustable-rate financial instruments, compared with 41 percent at December 31, 2005. Adjustable-rate financial instruments include variable-rate collateralized mortgage obligations, mortgage-backed securities, agency securities, adjustable-rate money market accounts and asset-backed securities.

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**Table 4** Investment Securities

| | Available-for-Sale | | | | Held-to-Maturity | | | |
|---|---|---|---|---|---|---|---|---|
| June 30, 2006 (Dollars in Millions) | Amortized Cost | Fair Value | Weighted-Average Maturity in Years | Weighted-Average Yield (d) | Amortized Cost | Fair Value | Weighted-Average Maturity in Years | Weighted-Average Yield (d) |
| **U.S. Treasury and agencies** | | | | | | | | |
| Maturing in one year or less | $119 | $119 | .3 | 4.70% | $ | $ | | % |
| Maturing after one year through five years | 37 | 37 | 2.4 | 6.39 | | | | |
| Maturing after five years through ten years | 14 | 14 | 6.9 | 7.10 | | | | |
| Maturing after ten years | 338 | 324 | 14.1 | 5.97 | | | | |
| Total | $508 | $494 | 9.8 | 5.73% | $ | $ | | % |
| **Mortgage-backed securities (a)** | | | | | | | | |
| Maturing in one year or less | $140 | $138 | .6 | 5.18% | $ | $ | | % |
| Maturing after one year through five years | 17,298 | 16,463 | 3.8 | 4.53 | 8 | 8 | 3.1 | 5.75 |
| Maturing after five years through ten years | 12,622 | 11,847 | 7.5 | 5.08 | | | | |
| Maturing after ten years | 5,793 | 5,715 | 15.1 | 6.36 | | | | |
| Total | $35,853 | $34,163 | 7.0 | 5.02% | $8 | $8 | 3.1 | 5.75% |
| **Asset-backed securities (a)** | | | | | | | | |
| Maturing in one year or less | $8 | $8 | .3 | 5.33% | $ | $ | | % |
| Maturing after one year through five years | | | | | | | | |
| Maturing after five years through ten years | | | | | | | | |
| Maturing after ten years | | | | | | | | |
| Total | $8 | $8 | .3 | 5.33% | $ | $ | | % |
| **Obligations of state and political subdivisions (b)** | | | | | | | | |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Maturing in one year or less | $52 | $52 | .4 | 7.00% | $2 | $2 | .5 | 6.04% |
| Maturing after one year through five years | 40 | 41 | 2.3 | 7.01 | 20 | 21 | 3.2 | 6.31 |
| Maturing after five years through ten years | 1,967 | 1,925 | 9.2 | 6.83 | 14 | 15 | 7.9 | 7.22 |
| Maturing after ten years | 742 | 720 | 14.3 | 6.44 | 37 | 38 | 15.8 | 6.54 |
| Total | $2,801 | $2,738 | 10.3 | 6.73% | $73 | $76 | 10.4 | 6.59% |
| **Other debt securities** | | | | | | | | |
| Maturing in one year or less | $256 | $256 | .1 | 4.57% | $5 | $5 | .4 | 6.44% |
| Maturing after one year through five years | 9 | 9 | 1.5 | 4.52 | 11 | 11 | 3.0 | 5.44 |
| Maturing after five years through ten years | 15 | 15 | 10.0 | 6.25 | 1 | 1 | 5.8 | 5.15 |
| Maturing after ten years | 627 | 625 | 21.2 | 6.06 | | | | |
| Total | $907 | $905 | 14.8 | 5.63% | $17 | $17 | 2.3 | 5.74% |
| **Other investments** | $54 | $56 | | % | $ | $ | | % |
| Total investment securities (c) | $40,131 | $38,364 | 7.4 | 5.17% | $98 | $101 | 8.4 | 6.37% |

*(a) Information related to asset and mortgage-backed securities included above is presented based upon weighted-average maturities anticipating future prepayments.*

*(b) Information related to obligations of state and political subdivisions is presented based upon yield to first optional call date if the security is purchased at a premium, yield to maturity if purchased at par or a discount.*

*(c) The weighted-average maturity of the available for sale investment securities was 6.1 years at December 31, 2005, with a corresponding weighted-average yield of 4.89 percent. The weighted-average maturity of the held-to-maturity investment securities was 7.2 years at December 31, 2005, with a corresponding weighted-average yield of 6.44 percent.*

*(d) Average yields are presented on a fully-taxable equivalent basis under a tax rate of 35 percent. Yields on available-for-sale and held-to-maturity securities are computed based on historical cost balances. Average yield and maturity calculations exclude equity securities that have no stated yield or maturity.*

| | June 30, 2006 | | December 31, 2005 | |
|---|---|---|---|---|
| (Dollars in Millions) | Amortized Cost | Percent of Total | Amortized Cost | Percent of Total |
| U.S. Treasury and agencies | $508 | 1.3% | $496 | 1.2% |
| Mortgage-backed securities | 35,861 | 89.1 | 38,169 | 94.4 |
| Asset-backed securities | 8 | | 12 | .1 |
| Obligations of state and political subdivisions | 2,874 | 7.1 | 724 | 1.8 |
| Other debt securities and investments | 978 | 2.5 | 1,029 | 2.5 |
| Total investment securities | $40,229 | 100.0% | $40,430 | 100.0% |

**Deposits** Total deposits were $122.7 billion at June 30, 2006, compared with $124.7 billion at December 31, 2005, a decrease of $2.0 billion (1.6 percent). The decrease in total deposits was primarily the result of decreases in noninterest-bearing deposits and money market savings accounts, partially offset by increases in interest checking, time certificates of deposits less than $100,000 and time deposits greater than $100,000. The $1.5 billion (4.6 percent) decrease in noninterest-bearing deposits reflected lower balances in most business lines, partially offset by an increase in corporate trust balances due to seasonality. The $1.3 billion (4.7 percent) decrease in money market savings account balances reflected the Company s deposit pricing decisions for money market products in relation to other fixed-rate deposit products offered. A portion of branch-based money market savings accounts have migrated to fixed-rate time certificates, while larger customer money market savings accounts have migrated to time deposits greater than $100,000 as rates increased on the time deposit products. Time deposits greater than $100,000 increased $.2 billion (1.0 percent) and time certificates of deposit less than $100,000 increased $.3 billion (2.1 percent) at June 30, 2006, compared with December 31, 2005. Interest checking accounts increased $.2 billion (1.0 percent) due to an increase in trust and custody balances, partially offset by decreases in consumer and private banking balances.

**Borrowings** The Company utilizes both short-term and long-term borrowings to fund growth of earning assets in excess of deposit growth. Short-term borrowings, which include federal funds purchased, commercial paper, securities sold under agreements to repurchase and other short-term borrowings, were $20.6 billion at June 30, 2006, compared with $20.2 billion at December 31, 2005. Short-term funding is managed within approved liquidity policies. The increase of $.4 billion in short-term borrowings reflected wholesale funding associated with the Company s earning asset growth and asset/liability management activities. Long-term debt was $42.0 billion at June 30, 2006, compared with $37.1 billion at December 31, 2005, reflecting the issuances of $2.0 billion of bank notes, $1.5 billion of medium-term notes and $1.8 billion of junior subordinated debentures and the addition of $2.2 billion of Federal Home Loan Bank ( FHLB ) advances, partially offset by $1.6 billion of medium-term note maturities and $.7 billion of junior subordinated debentures repayments. Refer to the Liquidity Risk Management section for discussion of liquidity management of the Company.

**CORPORATE RISK PROFILE**

**Overview** Managing risks is an essential part of successfully operating a financial services company. The most prominent risk exposures are credit, residual, operational, interest rate, market and liquidity risk. Credit risk is the risk of not collecting the interest and/or the principal balance of a loan or investment when it is due. Residual risk is the potential reduction in the end-of-term value of leased assets or the residual cash flows related to asset securitization and other off-balance sheet structures. Operational risk includes risks related to fraud, legal and compliance risk, processing errors, technology, breaches of internal controls and business continuation and disaster recovery risk. Interest rate risk is the potential reduction of net interest income as a result of changes in interest rates. Rate movements can affect the repricing of assets and liabilities differently, as well as their market value. Market risk arises from fluctuations in interest rates, foreign exchange rates, and equity prices that may result in changes in the values of financial instruments, such as trading and available-for-sale securities that are accounted for on a mark-to-market basis. Liquidity risk is the possible inability to fund obligations to depositors, investors or borrowers. In addition, corporate strategic decisions, as well as the risks described above, could give rise to reputation risk. Reputation risk is the risk that negative publicity or press, whether true or not, could result in costly litigation or cause a decline in the Company s stock value, customer base or revenue.

**Credit Risk Management** The Company s strategy for credit risk management includes well-defined, centralized credit policies, uniform underwriting criteria, and ongoing risk monitoring and review processes for all commercial and consumer credit exposures. The strategy also emphasizes diversification on a geographic, industry and customer level, regular credit examinations and management reviews of loans experiencing deterioration of credit quality. The credit risk management strategy also includes a credit risk assessment process, independent of business line managers, that performs assessments of compliance with commercial and consumer credit policies, risk ratings, and other critical credit information. The Company strives to identify potential problem loans early, take any necessary charge-offs promptly and maintain adequate reserve levels for probable loan losses inherent in the portfolio.

In evaluating its credit risk, the Company considers changes, if any, in underwriting activities, the loan portfolio composition (including product mix and

**Table 5** Delinquent Loan Ratios as a Percent of Ending Loan Balances

| 90 days or more past due **excluding** nonperforming loans | June 30, 2006 | December 31, 2005 |
|---|---|---|
| **Commercial** | | |
| Commercial | .06% | .06% |
| Lease financing | | |
| Total commercial | .05 | .05 |
| **Commercial real estate** | | |
| Commercial mortgages | | |
| Construction and development | .01 | |
| Total commercial real estate | | |
| **Residential mortgages** | .30 | .32 |
| **Retail** | | |
| Credit card | 1.56 | 1.26 |
| Retail leasing | .03 | .04 |
| Other retail | .18 | .22 |
| Total retail | .38 | .36 |
| Total loans | .19% | .18% |

| 90 days or more past due **including** nonperforming loans | June 30, 2006 | December 31, 2005 |
|---|---|---|
| Commercial | .58% | .69% |
| Commercial real estate | .40 | .55 |
| Residential mortgages (a) | .49 | .55 |
| Retail | .50 | .50 |
| Total loans | .51% | .58% |

(a) *Delinquent loan ratios exclude advances made pursuant to servicing agreements to Government National Mortgage Association ( GNMA ) mortgage pools whose repayments are insured by the Federal Housing Administration or guaranteed by the Department of Veterans Affairs. Including the guaranteed amounts, the ratio of residential mortgages 90 days or more past due was 3.06 percent at June 30, 2006, and 4.35 percent at December 31, 2005.*

geographic, industry or customer-specific concentrations), trends in loan performance, the level of allowance coverage relative to similar banking institutions and macroeconomic factors. Economic conditions during the second quarter and first six months of 2006 have improved from the same periods of 2005, as reflected in strong expansion of the gross domestic product index, lower unemployment rates, favorable trends related to corporate profits and consumer spending for retail goods and services. Current economic conditions are relatively unchanged from December 31, 2005. The Federal Reserve Bank continued increasing short-term interest rates in an effort to prevent an acceleration of inflation and maintain the current rate of economic growth.

Refer to Management s Discussion and Analysis Credit Risk Management in the Company s Annual Report on Form 10-K for the year ended December 31, 2005, for a more detailed discussion on credit risk management processes.

***Loan Delinquencies*** Trends in delinquency ratios represent an indicator, among other considerations, of credit risk within the Company s loan portfolios. The entire balance of the account is considered delinquent if the minimum payment contractually required to be made is not received by the specified date on the billing statement. The Company measures delinquencies, both including and excluding nonperforming loans, to enable comparability with other companies. Accruing loans 90 days or more past due totaled $264 million at June 30, 2006, compared with $253 million at December 31, 2005. These loans are not included in nonperforming assets and continue to accrue interest because they are adequately secured by collateral, and/or are in the process of collection and are reasonably expected to result in repayment or restoration to current status. The ratio of delinquent loans to total loans was .19 percent at June 30, 2006, and .18 percent at December 31, 2005.

To monitor credit risk associated with retail loans, the Company monitors delinquency ratios in the various stages of collection including nonperforming status.

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The following table provides summary delinquency information for residential mortgages and retail loans:

| (Dollars in Millions) | Amount | | As a Percent of Ending Loan Balances | |
|---|---|---|---|---|
| | June 30, 2006 | December 31, 2005 | June 30, 2006 | December 31, 2005 |
| **Residential mortgages** | | | | |
| 30-89 days | $105 | $112 | .50% | .55% |
| 90 days or more | 64 | 67 | .30 | .32 |
| Nonperforming | 39 | 48 | .19 | .23 |
| **Total** | $208 | $227 | .99% | 1.10% |
| **Retail** | | | | |
| **Credit card** | | | | |
| 30-89 days | $153 | $147 | 2.06% | 2.06% |
| 90 days or more | 116 | 90 | 1.56 | 1.26 |
| Nonperforming | 41 | 49 | .55 | .69 |
| **Total** | $310 | $286 | 4.17% | 4.01% |
| **Retail leasing** | | | | |
| 30-89 days | $26 | $43 | .36% | .59% |
| 90 days or more | 2 | 3 | .03 | .04 |
| Nonperforming | | | | |
| **Total** | $28 | $46 | .39% | .63% |
| **Other retail** | | | | |
| 30-89 days | $162 | $206 | .51% | .66% |
| 90 days or more | 58 | 70 | .18 | .22 |
| Nonperforming | 16 | 17 | .05 | .06 |
| **Total** | $236 | $293 | .74% | .94% |

***Nonperforming Assets*** The level of nonperforming assets represents another indicator of the potential for future credit losses. Nonperforming assets include nonaccrual loans, restructured loans not performing in accordance with modified terms, other real estate and other nonperforming assets owned by the Company. Interest payments collected from assets on nonaccrual status are typically applied against the principal balance and not recorded as income. At June 30, 2006, total nonperforming assets were $550 million, compared with $644 million at December 31, 2005. The ratio of total nonperforming assets to total loans and other real estate decreased to ..39 percent at June 30, 2006, compared with ..47 percent at December 31, 2005.

Included in nonperforming loans were restructured loans of $50 million at June 30, 2006, compared with $75 million at December 31, 2005. At June 30, 2006, the Company had no commitments to lend additional funds under restructured loans, compared to commitments of $9 million at December 31, 2005.

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**Table 6** Nonperforming Assets (a)

| (Dollars in Millions) | June 30, 2006 | December 31, 2005 |
|---|---|---|
| **Commercial** | | |
| Commercial | $203 | $231 |
| Lease financing | 38 | 42 |
| Total commercial | 241 | 273 |
| **Commercial real estate** | | |
| Commercial mortgages | 88 | 134 |
| Construction and development | 25 | 23 |
| Total commercial real estate | 113 | 157 |
| **Residential mortgages** | 39 | 48 |
| **Retail** | | |
| Credit card | 41 | 49 |
| Retail leasing | | |
| Other retail | 16 | 17 |
| Total retail | 57 | 66 |
| Total nonperforming loans | 450 | 544 |
| **Other real estate (b)** | 77 | 71 |
| **Other assets** | 23 | 29 |
| Total nonperforming assets | $550 | $644 |
| Accruing loans 90 days or more past due | $264 | $253 |
| Nonperforming loans to total loans | .32% | .39% |
| Nonperforming assets to total loans plus other real estate (b) | .39% | .47% |

**Changes in Nonperforming Assets**

| (Dollars in Millions) | Commercial and Commercial Real Estate | Retail and Residential Mortgages (d) | Total |
|---|---|---|---|
| **Balance December 31, 2005** | $457 | $187 | $644 |
| Additions to nonperforming assets | | | |
| New nonaccrual loans and foreclosed properties | 139 | 34 | 173 |
| Advances on loans | 18 | | 18 |
| Total additions | 157 | 34 | 191 |
| Reductions in nonperforming assets | | | |
| Paydowns, payoffs | (125) | (36) | (161) |

| | | | |
|---|---|---|---|
| Net sales | (21) | | (21) |
| Return to performing status | (30) | (4) | (34) |
| Charge-offs (c) | (61) | (8) | (69) |
| Total reductions | (237) | (48) | (285) |
| Net additions to (reductions in) nonperforming assets | (80) | (14) | (94) |
| **Balance June 30, 2006** | $377 | $173 | $550 |

*(a) Throughout this document, nonperforming assets and related ratios do not include accruing loans 90 days or more past due.*
*(b) Excludes $87 million of foreclosed GNMA loans which continue to accrue interest.*
*(c) Charge-offs exclude actions for certain card products and loan sales that were not classified as nonperforming at the time the charge-off occurred.*
*(d) Residential mortgage information excludes changes related to residential mortgages serviced by others.*

***Restructured Loans Accruing Interest*** On a case-by-case basis, management determines whether an account that experiences financial difficulties should be modified as to its interest rate or repayment terms to maximize the Company s collection of its balance.

Loans restructured at a rate equal to or greater than that of a new loan with comparable risk at the time the contract is modified are excluded from restructured loans once repayment performance, in accordance with the modified agreement, has been demonstrated over several payment cycles. Loans that have interest rates reduced below comparable market rates remain classified as restructured loans; however, interest income is accrued at the reduced rate as long as the customer complies with the revised terms and conditions.

The following table provides a summary of restructured loans that continue to accrue interest:

| | Amount | | As a Percent of Ending Loan Balances | |
|---|---|---|---|---|
| (Dollars in Millions) | June 30, 2006 | December 31, 2005 | June 30, 2006 | December 31, 2005 |
| Commercial | $ 16 | $ 5 | .04% | .01% |
| Commercial real estate | 1 | 1 | | |
| Residential mortgages | 65 | 59 | .31 | .28 |
| Credit card | 252 | 218 | 3.39 | 3.05 |
| Other retail | 36 | 32 | .09 | .08 |
| Total | $370 | $315 | .26% | .23% |

Restructured loans that continue to accrue interest were higher at June 30, 2006, compared with December 31, 2005, reflecting the impact of the Company implementing higher minimum balance payment requirements for credit card customers in response to industry guidance issued by the banking regulatory agencies.

***Analysis of Loan Net Charge-Offs*** Total loan net charge-offs were $125 million and $240 million during the second quarter and first six months of 2006, respectively, compared with net charge-offs of $144 million and $316 million, respectively, for the same periods of 2005. The ratio of total loan net charge-offs to average loans in the second quarter and first six months of 2006 was .36 percent and ..35 percent, respectively, compared with .44 percent and .49 percent, respectively, for the same periods of 2005.

Commercial and commercial real estate loan net charge-offs for the second quarter of 2006 were $20 million (.11 percent of average loans outstanding), compared with $13 million (.07 percent of average loans outstanding) in the second quarter of 2005. The increase in net charge-offs reflected lower gross charge-offs, more than offset by a lower level of recoveries as compared with the same quarter of the prior year. Commercial and commercial real estate loan net charge-offs for the first six months of 2006 were $34 million (.09 percent of average loans outstanding), compared with $46 million (.13 percent of average loans outstanding) in the first six months of 2005.

Retail loan net charge-offs for the second quarter of 2006 were $94 million (.82 percent of average loans outstanding), compared with $123 million (1.12 percent of average loans outstanding) for the second quarter of 2005. Retail loan net charge-offs for the first six months of 2006 were $188 million (.82 percent of average loans outstanding), compared with $253 million (1.17 percent of average loans outstanding) for the first six months of 2005. The decrease in retail loan net charge-offs reflected the impact of the bankruptcy legislation change that occurred in the fourth quarter of 2005. The Company anticipates that bankruptcy charge-offs will return to more normalized levels in future quarters.

The Company s retail lending business utilizes several distinct business processes and channels to originate retail credit including traditional branch lending, indirect lending and a consumer finance division. Each distinct underwriting and origination activity manages unique credit risk characteristics and prices its loan production commensurate with the differing risk profiles. Within Consumer Banking, U.S. Bank Consumer Finance ( USBCF ) participates in

**Table 7** Net Charge-offs as a Percent of Average Loans Outstanding

| | Three Months Ended | Six Months Ended |
|---|---|---|
| | June 30, | June 30, |

| | 2006 | 2005 | 2006 | 2005 |
|---|---|---|---|---|
| **Commercial** | | | | |
| Commercial | .13% | .10% | .09% | .13% |
| Lease financing | .54 | .49 | .55 | .78 |
| Total commercial | .18 | .14 | .15 | .20 |
| **Commercial real estate** | | | | |
| Commercial mortgages | (.02) | .02 | .01 | .05 |
| Construction and development | .05 | (.16) | .02 | (.03) |
| Total commercial real estate | | (.03) | .01 | .03 |
| **Residential mortgages** | .21 | .19 | .17 | .21 |
| **Retail** | | | | |
| Credit card | 2.72 | 3.93 | 2.67 | 4.02 |
| Retail leasing | .11 | .27 | .17 | .36 |
| Home equity and second mortgages | .35 | .43 | .34 | .45 |
| Other retail | .70 | 1.01 | .74 | 1.05 |
| Total retail | .82 | 1.12 | .82 | 1.17 |
| Total loans | .36% | .44% | .35% | .49% |

substantially all facets of the Company s consumer lending activities. USBCF specializes in serving channel-specific and alternative lending markets in residential mortgages, home equity and installment loan financing. USBCF manages loans originated through a broker network, correspondent relationships and U.S. Bank branch offices. Generally, loans managed by the Company s consumer finance division exhibit higher credit risk characteristics, but are priced commensurate with the differing risk profile.

The following table provides an analysis of net charge-offs as a percent of average loans outstanding managed by the consumer finance division, compared with traditional branch related loans:

| | Three Months Ended June 30 | | | | Six Months Ended June 30 | | | |
|---|---|---|---|---|---|---|---|---|
| | Average Loan Amount | | Percent of Average Loans | | Average Loan Amount | | Percent of Average Loans | |
| (Dollars in Millions) | 2006 | 2005 | 2006 | 2005 | 2006 | 2005 | 2006 | 2005 |
| **Consumer Finance (a)** | | | | | | | | |
| Residential mortgages | $7,295 | $5,788 | .49% | .49% | $7,055 | $5,455 | .46% | .52% |
| Home equity and second mortgages | 1,984 | 2,548 | 1.62 | 1.57 | 2,021 | 2,603 | 1.50 | 1.63 |
| Other retail | 402 | 387 | 3.99 | 4.15 | 403 | 385 | 4.50 | 4.71 |
| **Traditional Branch** | | | | | | | | |
| Residential mortgages | $13,573 | $11,410 | .06% | .04% | $13,872 | $11,062 | .03% | .05% |
| Home equity and second mortgages | 13,051 | 12,455 | .15 | .19 | 12,964 | 12,321 | .16 | .20 |
| Other retail | 16,218 | 14,747 | .62 | .92 | 16,180 | 14,616 | .65 | .95 |
| **Total Company** | | | | | | | | |
| Residential mortgages | $20,868 | $17,198 | .21% | .19% | $20,927 | $16,517 | .17% | .21% |
| Home equity and second mortgages | 15,035 | 15,003 | .35 | .43 | 14,985 | 14,924 | .34 | .45 |
| Other retail | 16,620 | 15,134 | .70 | 1.01 | 16,583 | 15,001 | .74 | 1.05 |

(a) *Consumer finance category included credit originated and managed by USBCF, as well as home equity and second mortgages with a loan-to-value greater than 100 percent that were originated in the branches.*

***Analysis and Determination of the Allowance for Credit Losses*** The allowance for loan losses provides coverage for probable and estimable losses inherent in the Company s loan and lease portfolio. Management evaluates the allowance each quarter to determine that it is adequate to cover these inherent losses. The evaluation of each element and the overall allowance is based on a continuing assessment of problem loans, recent loss experience and other factors, including regulatory guidance and economic conditions. Because business processes and credit risks associated with unfunded credit commitments are essentially the same as for loans, the Company utilizes similar processes to estimate its liability for unfunded credit commitments, which is included in other liabilities in the Consolidated Balance Sheet. Both the allowance for loan losses and the liability for unfunded credit commitments are included in the Company s analysis of the allowance for credit losses.

At June 30, 2006, the allowance for credit losses was $2,251 million (1.59 percent of loans), compared with an allowance of $2,251 million (1.63 percent of loans) at December 31, 2005. The ratio of the allowance for credit losses to nonperforming loans was 500 percent at June 30, 2006, compared with 414 percent at December 31, 2005. The ratio of the allowance for credit losses to annualized loan net charge-offs was 449 percent at June 30, 2006, compared with 329 percent at December 31, 2005.

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**Table 8** Summary of Allowance for Credit Losses

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| (Dollars in Millions) | 2006 | 2005 | 2006 | 2005 |
| Balance at beginning of period | $2,251 | $2,269 | $2,251 | $2,269 |
| **Charge-offs** | | | | |
| Commercial | | | | |
| Commercial | 24 | 42 | 52 | 74 |
| Lease financing | 13 | 15 | 25 | 38 |
| Total commercial | 37 | 57 | 77 | 112 |
| Commercial real estate | | | | |
| Commercial mortgages | 3 | 4 | 6 | 10 |
| Construction and development | 1 | 1 | 1 | 3 |
| Total commercial real estate | 4 | 5 | 7 | 13 |
| Residential mortgages | 11 | 8 | 19 | 18 |
| Retail | | | | |
| Credit card | 59 | 73 | 113 | 146 |
| Retail leasing | 6 | 8 | 13 | 19 |
| Home equity and second mortgages | 16 | 19 | 32 | 40 |
| Other retail | 43 | 52 | 90 | 105 |
| Total retail | 124 | 152 | 248 | 310 |
| Total charge-offs | 176 | 222 | 351 | 453 |
| **Recoveries** | | | | |
| Commercial | | | | |
| Commercial | 11 | 33 | 34 | 51 |
| Lease financing | 6 | 9 | 11 | 19 |
| Total commercial | 17 | 42 | 45 | 70 |
| Commercial real estate | | | | |
| Commercial mortgages | 4 | 3 | 5 | 5 |
| Construction and development | | 4 | | 4 |
| Total commercial real estate | 4 | 7 | 5 | 9 |
| Residential mortgages | | | 1 | 1 |
| Retail | | | | |
| Credit card | 9 | 9 | 17 | 17 |
| Retail leasing | 4 | 3 | 7 | 6 |
| Home equity and second mortgages | 3 | 3 | 7 | 7 |
| Other retail | 14 | 14 | 29 | 27 |
| Total retail | 30 | 29 | 60 | 57 |

| | | | | |
|---|---|---|---|---|
| Total recoveries | 51 | 78 | 111 | 137 |
| **Net Charge-offs** | | | | |
| Commercial | | | | |
| Commercial | 13 | 9 | 18 | 23 |
| Lease financing | 7 | 6 | 14 | 19 |
| Total commercial | 20 | 15 | 32 | 42 |
| Commercial real estate | | | | |
| Commercial mortgages | (1) | 1 | 1 | 5 |
| Construction and development | 1 | (3) | 1 | (1) |
| Total commercial real estate | | (2) | 2 | 4 |
| Residential mortgages | 11 | 8 | 18 | 17 |
| Retail | | | | |
| Credit card | 50 | 64 | 96 | 129 |
| Retail leasing | 2 | 5 | 6 | 13 |
| Home equity and second mortgages | 13 | 16 | 25 | 33 |
| Other retail | 29 | 38 | 61 | 78 |
| Total retail | 94 | 123 | 188 | 253 |
| Total net charge-offs | 125 | 144 | 240 | 316 |
| Provision for credit losses | 125 | 144 | 240 | 316 |
| Balance at end of period | $2,251 | $2,269 | $2,251 | $2,269 |
| | | | | |
| **Components** | | | | |
| Allowance for loan losses | $2,039 | $2,082 | | |
| Liability for unfunded credit commitments | 212 | 187 | | |
| Total allowance for credit losses | $2,251 | $2,269 | | |
| **Allowance for credit losses as a percentage of** | | | | |
| Period-end loans | 1.59% | 1.70% | | |
| Nonperforming loans | 500 | 441 | | |
| Nonperforming assets | 409 | 372 | | |
| Annualized net charge-offs | 449 | 393 | | |

Several factors were taken into consideration in evaluating the allowance for credit losses at June 30, 2006, including the risk profile of the portfolios and loan net charge-offs during the period, the level of nonperforming assets, accruing loans 90 days or more past due, delinquency ratios and changes in restructured loan balances compared with December 31, 2005. Management also considered the uncertainty related to certain industry sectors, including the airline industry, and the extent of credit exposure to other borrowers within the portfolio. In addition, concentration risks associated with commercial real estate and the mix of loans, including credit cards, loans originated through the consumer finance division and residential mortgages, and their relative credit risk were evaluated. Finally, the Company considered current economic conditions that might impact the portfolio.

**Residual Risk Management** The Company manages its risk to changes in the residual value of leased assets through disciplined residual valuation setting at the inception of a lease, diversification of its leased assets, regular residual asset valuation reviews and monitoring of residual value gains or losses upon the disposition of assets. As of June 30, 2006, no significant change in the amount of residuals or concentration of the portfolios has occurred since December 31, 2005. Refer to Management s Discussion and Analysis Residual Risk Management in the Company s Annual Report on Form 10-K for the year ended December 31, 2005, for further discussion on residual risk management.

**Operational Risk Management** The Company manages operational risk through a risk management framework and its internal control processes. Within this framework, the Corporate Risk Committee ( Risk Committee ) provides oversight and assesses the most significant operational risks facing the Company within its business lines. Under the guidance of the Risk Committee, enterprise risk management personnel establish policies and interact with business lines to monitor significant operational risks on a regular basis. Business lines have direct and primary responsibility and accountability for identifying, controlling, and monitoring operational risks embedded in their business activities. Refer to Management s Discussion and Analysis Operational Risk Management in the Company s Annual Report on Form 10-K for the year ended December 31, 2005, for further discussion on operational risk management.

**Interest Rate Risk Management** In the banking industry, changes in interest rates is a significant risk that can impact earnings, market valuations and safety and soundness of the entity. To minimize the volatility of net interest income and the market value of assets and liabilities, the Company manages its exposure to changes in interest rates through asset and liability management activities within guidelines established by its Asset Liability Policy Committee ( ALPC ) and approved by the Board of Directors. ALPC has the responsibility for approving and ensuring compliance with ALPC management policies, including interest rate risk exposure. The Company uses Net Interest Income Simulation Analysis and Market Value of Equity Modeling for measuring and analyzing consolidated interest rate risk.

***Net Interest Income Simulation Analysis*** One of the primary tools used to measure interest rate risk and the effect of interest rate changes on net interest income is simulation analysis. Through this simulation, management estimates the impact on net interest income of a 200 basis point upward or downward gradual change of market interest rates over a one-year period. This represents a change, effective in the first quarter of 2006, from a previous policy of estimating the effect of a 300 basis point upward or downward gradual change on net interest income. The simulation also estimates the effect of immediate and sustained parallel shifts in the yield curve of 50 basis points as well as the effect of immediate and sustained flattening or steepening of the yield curve.

Refer to Management s Discussion and Analysis Net Interest Income Simulation Analysis in the Company s Annual Report on Form 10-K for the year ended December 31, 2005, for further discussion on net interest income simulation analysis.

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Sensitivity of Net Interest Income:

| | June 30, 2006 | | | | December 31, 2005 | | | |
|---|---|---|---|---|---|---|---|---|
| | Down 50 Immediate | Up 50 Immediate | Down 200 Gradual | Up 200 Gradual | Down 50 Immediate | Up 50 Immediate | Down 200 Gradual* | Up 200 Gradual* |
| Net interest income | 1.17% | (1.39)% | 2.55% | (2.94)% | .66% | (.73)% | 1.19% | (2.60)% |

* *As of January 31, 2006, due to the change to a 200 basis point gradual change policy during the first quarter of 2006.*

The table above summarizes the interest rate risk of net interest income based on forecasts over the succeeding 12 months. At June 30, 2006, the Company s overall interest rate risk position was liability sensitive to changes in interest rates. The Company manages the overall interest rate risk profile within policy limits. ALPC policy guidelines limit the estimated change in net interest income to 3.0 percent of forecasted net interest income over the succeeding 12 months. At June 30, 2006, and December 31, 2005, the Company was within its policy guidelines.

***Market Value of Equity Modeling*** The Company also utilizes the market value of equity as a measurement tool in managing interest rate sensitivity. The market value of equity measures the degree to which the market values of the Company s assets and liabilities and off-balance sheet instruments will change given a change in interest rates. ALPC guidelines limit the change in market value of equity in a 200 basis point parallel rate shock to 15 percent of the market value of equity assuming interest rates at June 30, 2006. The up 200 basis point scenario resulted in a 6.2 percent decrease in the market value of equity at June 30, 2006, compared with a 6.8 percent decrease at December 31, 2005. The down 200 basis point scenario resulted in a 1.1 percent decrease in the market value of equity at June 30, 2006, compared with a 4.1 percent decrease at December 31, 2005. At June 30, 2006, and December 31, 2005, the Company was within its policy guidelines.

The Company also uses duration of equity as a measure of interest rate risk. The duration of equity is a measure of the net market value sensitivity of the assets, liabilities and derivative positions of the Company. The duration of assets was 1.9 years at June 30, 2006, compared with 1.6 years at December 31, 2005. The duration of liabilities was 1.8 years at June 30, 2006, compared with 1.6 years at December 31, 2005. At June 30, 2006, the duration of equity was 1.9 years, compared with 1.8 years at December 31, 2005. The increased duration of equity measure shows that sensitivity of the market value of equity of the Company was liability sensitive to changes in interest rates. Refer to Management s Discussion and Analysis Market Value of Equity Modeling in the Company s Annual Report on Form 10-K for the year ended December 31, 2005, for further discussion on market value of equity modeling.

***Use of Derivatives to Manage Interest Rate Risk*** In the ordinary course of business, the Company enters into derivative transactions to manage its interest rate, prepayment and foreign currency risks ( asset and liability management positions ) and to accommodate the business requirements of its customers ( customer-related positions ). Refer to Management s Discussion and Analysis Use of Derivatives to Manage Interest Rate Risk in the Company s Annual Report on Form 10-K for the year ended December 31, 2005, for further discussion on the use of derivatives to manage interest rate risk.

By their nature, derivative instruments are subject to market risk. The Company does not utilize derivative instruments for speculative purposes. Of the Company s $24.4 billion of total notional amount of asset and liability management derivative positions at June 30, 2006, $19.2 billion was designated as either fair value or cash flow hedges or net investment hedges of foreign operations. The cash flow hedge derivative positions are interest rate swaps that hedge the forecasted cash flows from the underlying variable-rate LIBOR loans and floating-rate debt. The fair value hedges are primarily interest rate swaps that hedge the change in fair value related to interest rate changes of underlying fixed-rate debt and subordinated obligations.

In addition, the Company uses forward commitments to sell residential mortgage loans to hedge its interest rate risk related to residential mortgage loans held for sale. Related to its mortgage banking operations, the Company held $2.3 billion of forward commitments to sell mortgage loans and $1.7 billion of unfunded mortgage loan commitments that were derivatives in accordance with the provisions of the Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedge Activities.* The unfunded mortgage loan commitments are reported at fair value as options in Table 9. Beginning in March 2006, the Company entered into U.S. Treasury futures and options on U.S. Treasury futures contracts to hedge the change in fair value related to the election of fair value measurement for its residential MSRs.

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**Table 9** Derivative Positions

| (Dollars in Millions) | June 30, 2006 Notional Amount | Fair Value | Weighted-Average Remaining Maturity In Years | December 31, 2005 Notional Amount | Fair Value | Weighted-Average Remaining Maturity In Years |
|---|---|---|---|---|---|---|
| **Asset and Liability Management Positions** | | | | | | |
| Interest rate contracts | | | | | | |
| Receive fixed/pay floating swaps | $5,810 | $(106) | 17.73 | $16,370 | $(82) | 7.79 |
| Pay fixed/receive floating swaps | 8,398 | 123 | 2.00 | 9,163 | 139 | 1.33 |
| Futures and forwards | | | | | | |
| Buy | 53 | | .11 | 104 | | .07 |
| Sell | 5,625 | (2) | .14 | 2,669 | (15) | .09 |
| Options | | | | | | |
| Written | 4,046 | (4) | .12 | 1,086 | 3 | .08 |
| Foreign exchange contracts | | | | | | |
| Cross-currency swaps | 403 | 19 | 9.12 | 387 | 11 | 9.61 |
| Forwards | 10 | | .08 | 404 | 7 | .05 |
| Equity contracts | 46 | 1 | 2.79 | 42 | 3 | 3.29 |
| **Customer-related Positions** | | | | | | |
| Interest rate contracts | | | | | | |
| Receive fixed/pay floating swaps | $10,218 | $(264) | 5.33 | $9,753 | $(69) | 5.25 |
| Pay fixed/receive floating swaps | 10,189 | 318 | 5.42 | 9,707 | 121 | 5.25 |
| Options | | | | | | |
| Purchased | 1,611 | 14 | 2.25 | 1,453 | 6 | 2.26 |
| Written | 1,597 | (13) | 2.25 | 1,453 | (5) | 2.26 |
| Risk participation agreements (a) | | | | | | |
| Purchased | 147 | | 7.49 | 143 | | 8.02 |
| Written | 224 | | 5.89 | 169 | | 4.64 |
| Foreign exchange rate contracts | | | | | | |
| Forwards and swaps | | | | | | |
| Buy | 2,265 | 67 | .39 | 2,042 | 77 | .43 |
| Sell | 2,212 | (59) | .41 | 2,018 | (73) | .46 |
| Options | | | | | | |
| Purchased | 134 | (1) | .46 | 56 | 1 | .24 |
| Written | 134 | 1 | .46 | 56 | (1) | .24 |

*(a) At June 30, 2006, the credit equivalent amount was $1 million and $32 million, compared with $1 million and $18 million at December 31, 2005, for purchased and written risk participation agreements, respectively.*

At June 30, 2006, the Company had $36 million in accumulated other comprehensive income related to realized and unrealized losses on derivatives classified as cash flow hedges. Unrealized gains and losses are reflected in earnings when the related cash flows or hedged transactions occur and offset the related performance of the hedged items. The estimated amount to be reclassified from accumulated other comprehensive income into earnings during the remainder of 2006 and the next 12 months is a gain of $21 million and $39 million, respectively.

Gains or losses on customer-related derivative positions were not material for the second quarter and first six months of 2006. The change in fair value of forward commitments attributed to hedge ineffectiveness recorded in noninterest income was not significant for the second quarter of 2006 and was a decrease of $1 million for the first six months of 2006. The change in the fair value of all other asset and liability management derivative positions attributed to hedge ineffectiveness recorded in noninterest income was not material for the second quarter and first six months of 2006.

The Company enters into derivatives to protect its net investment in certain foreign operations. The Company uses forward commitments to sell specified amounts of certain foreign currencies to hedge its capital volatility risk associated with fluctuations in foreign currency exchange rates. The net amount of gains or losses included in the cumulative translation adjustment for the second quarter and first six months of 2006 was not material.

**Market Risk Management** In addition to interest rate risk, the Company is exposed to other forms of market risk as a consequence of conducting normal trading activities. Business activities that contribute to market risk include primarily residential mortgage related risks, but also other things, such as proprietary trading and foreign exchange positions. Value at Risk ( VaR ) is a key measure of market risk for the Company. Theoretically, VaR represents the maximum amount that the Company has placed at risk of loss, with a ninety-ninth percentile degree of confidence, to adverse market movements in the course of its risk taking activities. Due to the election of fair value measurement of its residential MSRs and related hedging strategy in the first quarter of 2006, the Company increased its VaR limit to $40 million at March 31, 2006, compared with $20 million at December 31, 2005. The Company s market valuation risk, as estimated by the VaR analysis, was $16 million at June 30, 2006, compared with $1 million at December 31, 2005. Refer to Management s Discussion and Analysis Market Risk Management in the Company s Annual Report on Form 10-K for the year ended December 31, 2005, for further discussion on market risk management.

**Liquidity Risk Management** ALPC establishes policies, as well as analyzes and manages liquidity, to ensure that adequate funds are available to meet normal operating requirements in addition to unexpected customer demands for funds, such as high levels of deposit withdrawals or loan demand, in a timely and cost-effective manner. Liquidity management is viewed from long-term and short-term perspectives, as well as from an asset and liability perspective. Management monitors liquidity through a regular review of maturity profiles, funding sources, and loan and deposit forecasts to minimize funding risk. Refer to Management s Discussion and Analysis Liquidity Risk Management in the Company s Annual Report on Form 10-K for the year ended December 31, 2005, for further discussion on liquidity risk management.

At June 30, 2006, parent company long-term debt outstanding was $12.6 billion, compared with $10.9 billion at December 31, 2005. The $1.7 billion increase was primarily due to the issuances of $1.8 billion of junior subordinated debentures and $1.5 billion of medium-term notes, offset by long-term debt maturities and repayments during the first six months of 2006. As of June 30, 2006, there is no parent company debt scheduled to mature in the remainder of 2006.

Federal banking laws regulate the amount of dividends that may be paid by banking subsidiaries without prior approval. The amount of dividends available to the parent company from its banking subsidiaries after meeting the regulatory capital requirements for well-capitalized banks was approximately $1.1 billion at June 30, 2006.

***Off-Balance Sheet Arrangements*** Off-balance sheet arrangements include any contractual arrangement to which an unconsolidated entity is a party, under which the Company has an obligation to provide credit or liquidity enhancements or market risk support. Off-balance sheet arrangements include certain defined guarantees, asset securitization trusts and conduits. Off-balance sheet arrangements also include any obligation under a variable interest held by an unconsolidated entity that provides financing, liquidity, credit enhancement or market risk support.

In the ordinary course of business, the Company enters into an array of commitments to extend credit, letters of credit and various forms of guarantees that may be considered off-balance sheet arrangements. The extent of these arrangements is provided in Note 10 of the Notes to Consolidated Financial Statements.

Asset securitizations and conduits represent a source of funding for the Company through off-balance sheet structures. The Company sponsors an off-balance sheet conduit to which it transferred high-grade investment securities, funded by the issuance of commercial paper. The conduit held assets and related commercial paper liabilities of $3.0 billion at June 30, 2006, and $3.8 billion at December 31, 2005. The Company provides a liquidity facility to the conduit. A liability for the estimate of the potential risk of loss for the Company as the liquidity facility provider is recorded on the balance sheet in other liabilities and was $15 million at June 30, 2006, and $20 million at December 31, 2005. In addition, the Company recorded at fair value its retained residual interest in the investment securities conduit of $21 million at June 30, 2006, and $28 million at December 31, 2005.

The Company does not rely significantly on off-balance sheet arrangements for liquidity or capital resources. Refer to Management s Discussion and Analysis Off-Balance Sheet Arrangements in the Company s Annual Report on Form 10-K for the year ended December 31, 2005, for further discussion on off-balance sheet arrangements.

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**Table 10** Capital Ratios

| (Dollars in Millions) | June 30, 2006 | December 31, 2005 |
|---|---|---|
| Tier 1 capital | $16,841 | $15,145 |
| As a percent of risk-weighted assets | 8.9% | 8.2% |
| As a percent of adjusted quarterly average assets (leverage ratio) | 8.2% | 7.6% |
| Total risk-based capital | $24,893 | $23,056 |
| As a percent of risk-weighted assets | 13.1% | 12.5% |
| Tangible common equity | $11,535 | $11,873 |
| As a percent of tangible assets | 5.6% | 5.9% |

**Capital Management** The Company is committed to managing capital for maximum shareholder benefit and maintaining strong protection for depositors and creditors. The Company has targeted returning 80 percent of earnings to its common shareholders through a combination of dividends and share repurchases. In the first six months of 2006, the Company returned 116 percent of earnings. The Company continually assesses its business risks and capital position. The Company also manages its capital to exceed regulatory capital requirements for well-capitalized bank holding companies. To achieve these capital goals, the Company employs a variety of capital management tools including dividends, common share repurchases, and the issuance of subordinated debt and other capital instruments. Total shareholders equity was $20.4 billion at June 30, 2006, compared with $20.1 billion at December 31, 2005. The increase was the result of corporate earnings and the issuance of $1.0 billion of non-cumulative, perpetual preferred stock on March 27, 2006, partially offset by share repurchases and dividends.

Table 10 provides a summary of capital ratios as of June 30, 2006, and December 31, 2005. Tier 1 capital at June 30, 2006, was positively affected by the $1.0 billion issuance of preferred stock and the $1.8 billion issuance of junior subordinated debentures during the first six months of 2006. All regulatory ratios continue to be in excess of regulatory well-capitalized requirements.

On December 21, 2004, the Board of Directors approved and announced an authorization to repurchase 150 million shares of common stock during the next 24 months.

The following table provides a detailed analysis of all shares repurchased under this program during the second quarter of 2006:

| Period | Total Number of Shares Purchased as Part of the Program | Average Price Paid per Share | Maximum Number of Shares that May Yet Be Purchased Under the Program |
|---|---|---|---|
| April | 6,588,329 | $30.64 | 35,948,635 |
| May | 2,284,831 | 31.17 | 33,663,804 |
| June | 811,039 | 30.89 | 32,852,765 |
| Total | 9,684,199 | $30.78 | 32,852,765 |

On August 3, 2006, the Company announced that the Board of Directors approved an authorization to repurchase 150 million shares of common stock through December 2008. This new authorization replaces the December 21, 2004, share repurchase program.

**LINE OF BUSINESS FINANCIAL REVIEW**

Within the Company, financial performance is measured by major lines of business, which include Wholesale Banking, Consumer Banking, Wealth Management, Payment Services, and Treasury and Corporate Support. These operating segments are components of the Company about which financial information is available and is evaluated regularly in deciding how to allocate resources and assess performance.

**Basis for Financial Presentation** Business line results are derived from the Company s business unit profitability reporting systems by specifically attributing managed balance sheet assets, deposits and other liabilities and their related income or expense. Refer to Management s Discussion and Analysis Line of Business Financial Review in the Company s Annual Report on Form 10-K for the year ended December 31, 2005, for further discussion on the business lines basis for financial presentation.

Designations, assignments and allocations change from time to time as management systems are enhanced, methods of evaluating performance or product lines change or business segments are realigned to better respond to the Company s diverse customer base. During 2006, certain organization and methodology changes were made and, accordingly, 2005 results were restated and presented on a comparable basis, including a change in the allocation of risk adjusted capital to the business lines. Business lines are allocated risk adjusted capital based upon economic capital requirements, regulatory capital requirements, goodwill and intangibles. The allocations to the business lines are equal to the capital that is held by the Company. The capital allocations include credit and operational capital allocations which are performed using a Basel II approach with adjustments for regulatory Tier I leverage requirements.

**Wholesale Banking** offers lending, depository, treasury management and other financial services to middle market, large corporate, commercial real estate, equipment finance, small-ticket leasing and public sector clients, along with lending guaranteed by the Small Business Administration. Wholesale Banking contributed $298 million of the Company s net income in the second quarter and $598 million in the first six months of 2006, or increases of $6 million and $27 million, respectively, compared with the same periods of 2005. The increases were primarily driven by growth in total net revenue.

Total net revenue increased $21 million (3.1 percent) in the second quarter and $46 million (3.4 percent) in the first six months of 2006, compared with the same periods of 2005. Net interest income, on a taxable-equivalent basis, increased $15 million in the second quarter and $39 million in the first six months of 2006, compared with the same periods of 2005. The increases in net interest income were driven by growth in average loan balances and wider spreads on total deposits due to the funding benefit associated with the impact of rising interest rates, partially offset by reduced loan spreads due to competitive pricing. The increase in average loans was driven by stronger commercial loan and commercial real estate loan demand in 2005 and the first six months of 2006. Total deposits increased year-over-year driven by growth in fixed-rate time deposits, partially offset by a decrease in interest checking deposits.

The $6 million (2.7 percent) and $7 million (1.6 percent) increases in noninterest income in the second quarter and first six months of 2006, respectively, compared with the same periods of 2005, were due to higher commercial products revenue and equipment leasing revenue, partially offset by lower other commercial loan fees and treasury management-related fees. Treasury management-related fees were lower due to higher earnings credits on customers compensating balances, partially offset by growth in treasury management-related services activity.

Noninterest expense was relatively flat in the second quarter of 2006, compared with the second quarter of 2005. Noninterest expense increased $8 million (1.7 percent) in the first six months of 2006, compared with the same period of 2005. The increase was primarily driven by higher personnel-related costs and net shared services expense.

The provision for credit losses increased $12 million in the second quarter and decreased $5 million in the first six months of 2006, compared with the same periods of 2005. The increase in the provision for credit losses in the second quarter of 2006 was due to lower net recoveries compared to the second quarter of 2005. Nonperforming assets within Wholesale Banking were $218 million at June 30, 2006, $260 million at March 31, 2006, and $298 million at June 30, 2005. Nonperforming assets as a percentage of period-end loans were .43 percent at June 30, 2006, ..52 percent at March 31, 2006, and .63 percent at June 30, 2005. Refer to the Corporate Risk Profile section for further information on factors impacting the credit quality of the loan portfolios.

**Consumer Banking** delivers products and services through banking offices, telephone servicing and sales, on-line services, direct mail and ATMs. It encompasses community banking, metropolitan banking, in-store banking, small business banking, consumer lending, mortgage banking, consumer finance, workplace banking, student banking and 24-hour banking. Consumer Banking contributed $488 million of the Company s net income in the second quarter and $899 million in the first six months of 2006, or increases of $59 million and $83, respectively, compared with the same periods of 2005. While the retail banking business grew net income 13.9 percent in the second quarter and 11.2 percent in the first six months of 2006, the contribution of the mortgage banking business increased 12.5 percent and decreased 3.4 percent, respectively, compared with the same periods of 2005.

Total net revenue increased $22 million (1.6 percent) in the second quarter and $31 million (1.1 percent) in the first six months of 2006, compared with the same periods of 2005. Net interest income, on a taxable-equivalent basis, increased $19 million in the second quarter and $56 million in the first six months of 2006, compared with the same periods of 2005. The year-over-year increases in net interest income were due to strong growth in average loans and the funding benefit of total deposits due to rising interest rates. Partially offsetting these increases were reduced spreads on commercial and retail loans due to competitive pricing. The increases in average loan balances reflected growth in retail loans, residential mortgages, commercial loans and commercial real estate loans. The growth in retail loans was principally driven by an increase in installment loans which increased 15.8 percent in the second quarter and 15.5 percent in the first six months of 2006 over the same periods of 2005. Residential mortgages, which include traditional residential mortgages, grew 21.6 percent in the second

quarter and 27.1 percent in the first six months of 2006, compared with the same periods of a year ago, reflecting the Company s retention of adjustable-rate residential mortgages during 2005. Average balances of residential mortgages are expected to remain essentially flat in future periods due to the Company s decision in the first quarter of 2006 to package and sell the majority of its residential mortgage loan production in the secondary markets. The year-over-year decreases in average deposits were primarily due to a reduction in saving products, offset by growth in interest checking and time deposits. The year-over-year increases in interest checking balances reflected strong branch-based new account deposit growth. On a combined basis, the Consumer Banking line of business generated growth of $90 million (.3 percent) in average checking account balances in the second quarter of 2006, compared with the second quarter of 2005, driven by 5.7 percent growth in net new checking accounts. Offsetting this growth was a decline in average savings balances of $3.2 billion (13.0 percent) from second quarter of 2005, principally related to money market accounts. Average time deposit balances grew $1.6 billion in the second quarter and $1.7 billion in the first six months of 2006, compared with the same periods of 2005, as a portion of money market balances migrated to fixed-rate time deposit products.

Fee-based noninterest income increased $3 million in the second quarter and decreased $25 million in the first six months of 2006, compared with the same periods of 2005. The year-over-year decline in fee-based revenue was driven by a reduction in mortgage banking revenue, partially offset by increases in deposit service charges, retail leasing revenue, and other revenue. The increase in other revenue reflected higher gains from the sales of student loans. The reduction in mortgage banking revenue reflected the adoption of fair value accounting for MSRs as of January 1, 2006.

Noninterest expense decreased $61 million (9.1 percent) in the second quarter and $78 million (5.9 percent) in the first six months of 2006, compared with the same periods of 2005. The decreases were primarily attributable to the elimination of MSR amortization under SFAS 156 which resulted in a reduction of other intangible expense. Partially offsetting this decrease were increases in compensation and employee benefit expenses. The increases in compensation and employee benefit expenses reflect the impact of the net addition of 38 in-store and 13 traditional branches at June 30, 2006, compared with June 30, 2005.

The provision for credit losses decreased $9 million and $20 million in the second quarter and first six months of 2006, respectively, compared with the same periods of 2005. The improvements were attributable to lower net charge-offs. As a percentage of average loans outstanding, net charge-offs declined to .30 percent in the second quarter of 2006, compared with .38 percent in the second quarter of 2005. The decline in net charge-offs included both the commercial and retail loan portfolios. Commercial and commercial real estate loan net charge-offs declined $3 million in the second quarter of 2006, compared with the second quarter of 2005. Retail loan and residential mortgage net charge-offs declined by $6 million in the second quarter of 2006, compared with the second quarter of 2005. Nonperforming assets within Consumer Banking were $275 million at June 30, 2006, $291 million at March 31, 2006, and $304 million at June 30, 2005. Nonperforming assets as a percentage of period-end loans were .39 percent at June 30, 2006, ..42 percent at March 31, 2006, and .49 percent at June 30, 2005. Refer to the Corporate Risk Profile section for further information on factors impacting the credit quality of the loan portfolios.

**Wealth Management** provides trust, private banking, financial advisory, investment management, insurance, custody and mutual fund servicing through six businesses: Private Client Group, Corporate Trust, U.S. Bancorp Investments and Insurance, FAF Advisors, Institutional Trust and Custody and Fund Services. Wealth Management contributed $148 million of the Company s net income in the second quarter and $282 million in the first six months of 2006, or increases of $32 million and $55 million, respectively, compared with the same periods of 2005. The growth was primarily attributable to higher total net revenue, partially offset by an increase in noninterest expense.

Total net revenue increased $88 million (21.6 percent) in the second quarter and $170 million (21.2 percent) in the first six months of 2006, compared with the same periods of 2005. Net interest income, on a taxable-equivalent basis, increased $21 million in the second quarter and $47 million in the first six months of 2006, compared with the same periods of 2005. The increases in net interest income were due to growth in total average deposits and the favorable impact of rising interest rates on the funding benefit of customer deposits, partially offset by a decline in loan spreads. The increase in total deposits was attributable to growth in noninterest-bearing deposits and time deposits principally in Corporate Trust. Noninterest income increased $67 million in the second quarter and $123 million in the first six months of 2006, compared with the same periods of 2005, primarily driven by the acquisition of the corporate and institutional trust business of a large national bank, growth in core revenue, and favorable equity market valuations.

Noninterest expense increased $39 million (17.5 percent) in the second quarter and $84 million (19.0 percent) in the first six months of 2006, compared with the same periods of 2005. The increases in noninterest expense were primarily attributable to the acquisition of a large national bank s corporate and institutional trust business.

**Payment Services** includes consumer and business credit cards, stored-value cards, debit cards, corporate and purchasing card services, consumer lines of credit, ATM processing and merchant processing. Payment Services contributed $251 million of the Company s net income in the second quarter and $474 in the first six months of 2006, or increases of $68 million and $123 million, respectively, compared with the same periods of 2005. The increases were due to growth in total net revenue driven by higher transaction volumes and a lower provision for credit losses, partially offset by increases in total noninterest expense.

Total net revenue increased $128 million (18.8 percent) in the second quarter and $251 million (19.1 percent) in the first six months of 2006, compared with the same periods of 2005. Net interest income increased $21 million in the second quarter and $38 million in the first six months of 2006, compared with the same periods of 2005. The increases were primarily due to increases in retail credit card balances and customer late fees, partially offset by an increase in nonearning assets resulting in higher funding expense. Noninterest income increased $107 million in the second quarter and $213 million in the first six months of 2006, compared with the same periods of 2005. The increases in fee-based revenue were driven by strong growth in credit card and debit card revenue, corporate payment products revenue, ATM processing services revenue and merchant processing revenue. Credit and debit card revenue increased due to higher customer transaction volume. Corporate payment products revenue reflected organic growth in sales volumes and card usage. ATM processing services revenue increased primarily due to the acquisition of an ATM business in May of 2005. Merchant processing revenue also grew from a year ago due to an increase in sales volume driven by acquisitions, higher same store sales and equipment fees. Noninterest income for the first six months of 2006 also included the impact of a $10 million settlement in the first quarter.

Noninterest expense increased $48 million (15.8 percent) in the second quarter and $113 million (19.5 percent) in the first six months of 2006, compared with the same periods of 2005. The increases in noninterest expense were primarily attributable to the acquisition of merchant acquiring businesses, higher compensation and employee benefit costs for processing associated with increased credit and debit card transaction volumes, higher corporate payment products and merchant processing sales volumes, and higher ATM processing services volumes.

The provision for credit losses decreased $27 million (29.3 percent) in the second quarter and $56 million (30.9 percent) in the first six months of 2006, compared with the same periods of 2005, due to lower net charge-offs. As a percentage of average loans outstanding, net charge-offs were 2.16 percent in the second quarter of 2006, compared with 3.26 percent in the second quarter of 2005. The favorable change in credit losses reflected the near-term impact of changes in bankruptcy legislation in the fourth quarter of 2005.

**Treasury and Corporate Support** includes the Company s investment portfolios, funding, capital management and asset securitization activities, interest rate risk management, the net effect of transfer pricing related to average balances and the residual aggregate of those expenses associated with corporate activities that are managed on a consolidated basis. In addition, prior to the adoption of SFAS 156, changes in MSR valuations due to interest rate changes were managed at a corporate level and, as such, reported within this business unit. Treasury and Corporate Support recorded net income of $16 million in the second quarter and $101 million in the first six months of 2006, or decreases of $85 million and $126 million, respectively, compared with the same periods of 2005.

Total net revenue decreased $109 million (92.4 percent) in the second quarter and $142 million (61.2 percent) in the first six months of 2006, compared with the same periods of 2005. The year-over-year decreases in total net revenue were primarily due to unfavorable variances in net interest income, partially offset by higher noninterest income. The decrease in net interest income reflected the impact of a flatter yield curve and asset/liability management decisions during the past year, including reducing the investment securities portfolio, changes in interest rate derivative positions and the issuance of higher cost wholesale funding. Noninterest income increased $31 million in the second quarter and $128 million in the first six months of 2006, compared with the same periods of 2005. The increase in noninterest income in the second quarter and first six months of 2006 was driven by a gain from an initial public offering of a cardholder association. The increase during the first six months of 2006 was also due to a gain on derivatives that did not qualify as hedges, realized in the first quarter of 2006, and securities losses incurred in the first six months of 2005.

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**Table 11** Line of Business Financial Performance

| Three Months Ended June 30 (Dollars in Millions) | Wholesale Banking 2006 | Wholesale Banking 2005 | Percent Change | Consumer Banking 2006 | Consumer Banking 2005 | Percent Change |
|---|---|---|---|---|---|---|
| **Condensed Income Statement** | | | | | | |
| Net interest income (taxable-equivalent basis) | $478 | $463 | 3.2% | $968 | $949 | 2.0% |
| Noninterest income | 224 | 220 | 1.8 | 465 | 462 | .6 |
| Securities gains (losses), net | 2 | | * | | | |
| Total net revenue | 704 | 683 | 3.1 | 1,433 | 1,411 | 1.6 |
| Noninterest expense | 230 | 231 | (.4) | 600 | 609 | (1.5) |
| Other intangibles | 4 | 4 | | 12 | 64 | (81.3) |
| Total noninterest expense | 234 | 235 | (.4) | 612 | 673 | (9.1) |
| Income before provision and income taxes | 470 | 448 | 4.9 | 821 | 738 | 11.2 |
| Provision for credit losses | 1 | (11) | * | 54 | 63 | (14.3) |
| Income before income taxes | 469 | 459 | 2.2 | 767 | 675 | 13.6 |
| Income taxes and taxable-equivalent adjustment | 171 | 167 | 2.4 | 279 | 246 | 13.4 |
| Net income | $298 | $292 | 2.1 | $488 | $429 | 13.8 |
| **Average Balance Sheet Data** | | | | | | |
| Commercial | $33,292 | $31,187 | 6.7% | $6,380 | $6,143 | 3.9% |
| Commercial real estate | 17,346 | 16,630 | 4.3 | 10,699 | 10,226 | 4.6 |
| Residential mortgages | 59 | 57 | 3.5 | 20,365 | 16,742 | 21.6 |
| Retail | 40 | 28 | 42.9 | 35,112 | 33,710 | 4.2 |
| Total loans | 50,737 | 47,902 | 5.9 | 72,556 | 66,821 | 8.6 |
| Goodwill | 1,329 | 1,329 | | 2,108 | 2,108 | |
| Other intangible assets | 55 | 73 | (24.7) | 1,453 | 1,168 | 24.4 |
| Assets | 56,934 | 53,886 | 5.7 | 80,774 | 74,795 | 8.0 |
| Noninterest-bearing deposits | 12,107 | 12,303 | (1.6) | 12,720 | 13,035 | (2.4) |
| Interest checking | 3,164 | 3,189 | (.8) | 17,789 | 17,384 | 2.3 |
| Savings products | 5,569 | 5,469 | 1.8 | 21,393 | 24,581 | (13.0) |
| Time deposits | 13,020 | 12,267 | 6.1 | 18,669 | 17,034 | 9.6 |
| Total deposits | 33,860 | 33,228 | 1.9 | 70,571 | 72,034 | (2.0) |
| Shareholders equity | 5,554 | 5,308 | 4.6 | 6,436 | 6,457 | (.3) |

| Six Months Ended June 30 (Dollars in Millions) | Wholesale Banking 2006 | Wholesale Banking 2005 | Percent Change | Consumer Banking 2006 | Consumer Banking 2005 | Percent Change |
|---|---|---|---|---|---|---|
| **Condensed Income Statement** | | | | | | |
| Net interest income (taxable-equivalent basis) | $950 | $911 | 4.3% | $1,918 | $1,862 | 3.0% |
| Noninterest income | 449 | 448 | .2 | 848 | 873 | (2.9) |
| Securities gains (losses), net | 2 | (4) | * | | | |
| Total net revenue | 1,401 | 1,355 | 3.4 | 2,766 | 2,735 | 1.1 |
| Noninterest expense | 459 | 451 | 1.8 | 1,211 | 1,188 | 1.9 |
| Other intangibles | 8 | 8 | | 25 | 126 | (80.2) |
| Total noninterest expense | 467 | 459 | 1.7 | 1,236 | 1,314 | (5.9) |
| Income before provision and income taxes | 934 | 896 | 4.2 | 1,530 | 1,421 | 7.7 |
| Provision for credit losses | (7) | (2) | * | 117 | 137 | (14.6) |
| Income before income taxes | 941 | 898 | 4.8 | 1,413 | 1,284 | 10.0 |
| Income taxes and taxable-equivalent adjustment | 343 | 327 | 4.9 | 514 | 468 | 9.8 |
| Net income | $598 | $571 | 4.7 | $899 | $816 | 10.2 |
| **Average Balance Sheet Data** | | | | | | |
| Commercial | $32,866 | $30,709 | 7.0% | $6,345 | $6,010 | 5.6% |
| Commercial real estate | 17,312 | 16,615 | 4.2 | 10,650 | 10,194 | 4.5 |
| Residential mortgages | 61 | 60 | 1.7 | 20,420 | 16,069 | 27.1 |
| Retail | 42 | 38 | 10.5 | 35,075 | 33,425 | 4.9 |
| Total loans | 50,281 | 47,422 | 6.0 | 72,490 | 65,698 | 10.3 |
| Goodwill | 1,329 | 1,329 | | 2,107 | 2,109 | (.1) |
| Other intangible assets | 57 | 76 | (25.0) | 1,392 | 1,141 | 22.0 |
| Assets | 56,287 | 53,248 | 5.7 | 80,405 | 73,251 | 9.8 |
| Noninterest-bearing deposits | 12,049 | 12,125 | (.6) | 12,747 | 12,937 | (1.5) |
| Interest checking | 3,139 | 3,397 | (7.6) | 17,722 | 17,198 | 3.0 |
| Savings products | 5,427 | 5,351 | 1.4 | 21,877 | 25,027 | (12.6) |
| Time deposits | 12,536 | 11,660 | 7.5 | 18,422 | 16,760 | 9.9 |
| Total deposits | 33,151 | 32,533 | 1.9 | 70,768 | 71,922 | (1.6) |
| Shareholders equity | 5,474 | 5,296 | 3.4 | 6,424 | 6,445 | (.3) |

* *Not meaningful*

| Wealth Management | | | Payment Services | | | Treasury and Corporate Support | | | Consolidated Company | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 2006 | 2005 | Percent Change | 2006 | 2005 | Percent Change | 2006 | 2005 | Percent Change | 2006 | 2005 | Percent Change |
| $127 | $106 | 19.8% | $156 | $135 | 15.6% | $(32) | $108 | *% | $1,697 | $1,761 | (3.6)% |
| 369 | 302 | 22.2 | 654 | 547 | 19.6 | 40 | 9 | * | 1,752 | 1,540 | 13.8 |
| | | | | | | 1 | 1 | | 3 | 1 | * |
| 496 | 408 | 21.6 | 810 | 682 | 18.8 | 9 | 118 | (92.4) | 3,452 | 3,302 | 4.5 |
| 240 | 208 | 15.4 | 300 | 260 | 15.4 | 71 | 106 | (33.0) | 1,441 | 1,414 | 1.9 |
| 22 | 15 | 46.7 | 51 | 43 | 18.6 | | 55 | * | 89 | 181 | (50.8) |
| 262 | 223 | 17.5 | 351 | 303 | 15.8 | 71 | 161 | (55.9) | 1,530 | 1,595 | (4.1) |
| 234 | 185 | 26.5 | 459 | 379 | 21.1 | (62) | (43) | (44.2) | 1,922 | 1,707 | 12.6 |
| 2 | 2 | | 65 | 92 | (29.3) | 3 | (2) | * | 125 | 144 | (13.2) |
| 232 | 183 | 26.8 | 394 | 287 | 37.3 | (65) | (41) | (58.5) | 1,797 | 1,563 | 15.0 |
| 84 | 67 | 25.4 | 143 | 104 | 37.5 | (81) | (142) | 43.0 | 596 | 442 | 34.8 |
| $148 | $116 | 27.6 | $251 | $183 | 37.2 | $16 | $101 | (84.2) | $1,201 | $1,121 | 7.1 |
| $1,520 | $1,582 | (3.9)% | $3,758 | $3,433 | 9.5% | $120 | $172 | (30.2)% | $45,070 | $42,517 | 6.0% |
| 689 | 639 | 7.8 | | | | 61 | 87 | (29.9) | 28,795 | 27,582 | 4.4 |
| 440 | 393 | 12.0 | | | | 4 | 6 | (33.3) | 20,868 | 17,198 | 21.3 |
| 2,422 | 2,313 | 4.7 | 8,512 | 7,878 | 8.0 | 44 | 49 | (10.2) | 46,130 | 43,978 | 4.9 |
| 5,071 | 4,927 | 2.9 | 12,270 | 11,311 | 8.5 | 229 | 314 | (27.1) | 140,863 | 131,275 | 7.3 |
| 1,378 | 874 | 57.7 | 2,463 | 2,030 | 21.3 | 1 | | * | 7,279 | 6,341 | 14.8 |
| 473 | 316 | 49.7 | 1,165 | 972 | 19.9 | | 3 | * | 3,146 | 2,532 | 24.2 |
| 7,487 | 6,647 | 12.6 | 17,294 | 15,163 | 14.1 | 49,918 | 51,327 | (2.7) | 212,407 | 201,818 | 5.2 |
| 3,668 | 3,616 | 1.4 | 297 | 134 | * | 157 | 60 | * | 28,949 | 29,148 | (.7) |
| 2,379 | 2,445 | (2.7) | | | | 1 | 6 | (83.3) | 23,333 | 23,024 | 1.3 |
| 5,677 | 5,368 | 5.8 | 19 | 15 | 26.7 | 43 | 16 | * | 32,701 | 35,449 | (7.8) |
| 2,900 | 1,102 | * | 3 | 1 | * | 1,658 | 3,207 | (48.3) | 36,250 | 33,611 | 7.9 |
| 14,624 | 12,531 | 16.7 | 319 | 150 | * | 1,859 | 3,289 | (43.5) | 121,233 | 121,232 | |
| 2,349 | 1,663 | 41.3 | 4,747 | 4,011 | 18.3 | 1,470 | 2,381 | (38.3) | 20,556 | 19,820 | 3.7 |

| Wealth Management | | Payment Services | | Treasury and Corporate Support | | Consolidated Company | |
|---|---|---|---|---|---|---|---|
| | Percent | | Percent | | Percent | | Percent |

| 2006 | 2005 | Change | 2006 | 2005 | Change | 2006 | 2005 | Change | 2006 | 2005 | Change |
|---|---|---|---|---|---|---|---|---|---|---|---|
| $252 | $205 | 22.9% | $319 | $281 | 13.5% | $(17) | $253 | *% | $3,422 | $3,512 | (2.6)% |
| 719 | 596 | 20.6 | 1,244 | 1,031 | 20.7 | 106 | 33 | * | 3,366 | 2,981 | 12.9 |
| | | | | | | 1 | (54) | * | 3 | (58) | * |
| 971 | 801 | 21.2 | 1,563 | 1,312 | 19.1 | 90 | 232 | (61.2) | 6,791 | 6,435 | 5.5 |
| 482 | 411 | 17.3 | 596 | 496 | 20.2 | 108 | 128 | (15.6) | 2,856 | 2,674 | 6.8 |
| 44 | 31 | 41.9 | 97 | 84 | 15.5 | | 3 | * | 174 | 252 | (31.0) |
| 526 | 442 | | | | | | | | | | |

| | | | |
|---|---|---|---|
| Purchases of available-for-sale investments | (237,968) | (151,470) | (555,798) |
| Proceeds from sales and maturities of marketable securities | 153,275 | 304,928 | 565,336 |
| Purchases of property and equipment | (8,943) | (12,525) | (5,387) |
| Proceeds from the sale of assets | | 14,265 | 270,750 |
| Purchases of other assets | (6,408) | (7,551) | (9,502) |
| Acquisitions of businesses, net of cash acquired | (4,300) | (78,477) | (8,540) |
| Net cash provided by (used in) investing activities of continuing operations | (104,344) | 69,170 | 256,859 |
| **Financing Activities** | | | |
| Proceeds from issuance of common stock, net of shares withheld for taxes | 25,187 | 4,264 | 15,362 |
| Excess income tax | 1,862 | 888 | 1,959 |

| | | | |
|---|---|---|---|
| benefit from employee stock-based awards | | | |
| Repurchases of common stock | (20,181) | (286,140) | (157,332) |
| Net cash provided by (used in) financing activities of continuing operations | 6,868 | (280,988) | (140,011) |
| **Discontinued Operations** | | | |
| Operating activities | | | 10,794 |
| Investing activities | | | (1,654) |
| Financing activities | | | 26,245 |
| Net cash provided by discontinued operations | | | 35,385 |
| Increase (decrease) in cash and cash equivalents | 23,465 | (92,136) | 196,220 |
| Cash and cash equivalents at beginning of period | 172,272 | 264,408 | 68,188 |
| Cash and cash equivalents at end of period | $ 195,737 | $ 172,272 | $ 264,408 |
| **Supplemental Disclosure of Cash Flow Information:** | | | |
| Interest paid | $ 279 | $ 440 | $ 703 |
| Income taxes paid | $ 4,500 | $ 18,613 | $ 49,191 |

The accompanying notes are an integral part of these Consolidated Financial Statements.

**Silicon Laboratories Inc.**
**Notes to Consolidated Financial Statements**
**January 2, 2010**

## 1. Description of Business

Silicon Laboratories Inc. (the "Company"), a Delaware corporation, develops and markets mixed-signal analog intensive integrated circuits (ICs) for a broad range of applications for global markets. Within the semiconductor industry, the Company is known as a "fabless" company meaning that the ICs are manufactured by third-party foundry semiconductor companies.

In March 2007, the Company sold its Aero transceiver, AeroFONE single-chip phone and power amplifier product lines (the "Aero product lines") to NXP B.V. and NXP Semiconductors France SAS (collectively "NXP"). The financial results of the sold product lines have been presented as discontinued operations in the Consolidated Financial Statements. See Note 3, *Discontinued Operation*, for additional information.

## 2. Significant Accounting Policies

*Basis of Presentation and Principles of Consolidation*

The Company prepares financial statements on a 52-53 week year that ends on the Saturday closest to December 31. Fiscal 2009 had 52 weeks and ended January 2, 2010. Fiscal 2008 had 53 weeks with the extra week occurring in the first quarter of the year and ended January 3, 2009. Fiscal year 2007 had 52 weeks and ended December 29, 2007. The accompanying Consolidated Financial Statements include the accounts of the Company and its wholly owned subsidiaries. All significant intercompany balances and transactions have been eliminated.

*Foreign Currency Transactions*

The functional currency of the Company's foreign subsidiaries is the U.S. dollar; accordingly, all gains and losses resulting from remeasuring transactions denominated in currencies other than U.S. dollars are included in net income.

*Use of Estimates*

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Among the significant estimates affecting the financial statements are those related to inventories, stock compensation, investments in auction-rate securities, goodwill, long-lived assets and income taxes. Actual results could differ from those estimates, and such differences could be material to the financial statements.

*Reclassifications*

Certain reclassifications have been made to prior year financial statements to conform to current year presentation.

**Silicon Laboratories Inc.**
**Notes to Consolidated Financial Statements (Continued)**
**January 2, 2010**

**2. Significant Accounting Policies (Continued)**

*Fair Value of Financial Instruments*

The fair values of the Company's financial instruments are recorded using a hierarchal disclosure framework based upon the level of subjectivity of the inputs used in measuring assets and liabilities. The three levels are described below:

Level 1 Inputs are unadjusted, quoted prices in active markets for identical assets or liabilities at the measurement date.

Level 2 Inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly.

Level 3 Inputs are unobservable for the asset or liability and are developed based on the best information available in the circumstances, which might include the Company's own data.

*Cash and Cash Equivalents*

Cash and cash equivalents consist of cash deposits, money market funds and investments in debt securities with original maturities of ninety days or less when purchased.

*Investments*

The Company's investments consist primarily of U.S. government agency bonds and discount notes, corporate bonds, municipal bonds, U.S. Treasury bills, commercial paper, international government bonds and auction-rate securities. These securities typically have original maturities greater than ninety days as of the date of purchase and are classified as available-for-sale or trading securities. Investments in available-for-sale securities are reported at fair value, with unrealized gains and losses, net of tax, recorded as a component of accumulated other comprehensive loss in the Consolidated Balance Sheet. Investments in trading securities are reported at fair value, with both realized and unrealized gains and losses recorded in other income (expense), net in the Consolidated Statement of Income. Investments in which the Company has the ability and intent, if necessary, to liquidate in order to support its current operations (including those with contractual maturities greater than one year from the date of purchase) are classified as short-term. The Company's long-term investments consist of auction-rate securities.

The Company reviews its available-for-sale investments as of the end of each reporting period for other-than-temporary declines in fair value based on the specific identification method. The Company considers various factors in determining whether an impairment is other-than-temporary, including the severity and duration of the impairment, changes in underlying credit ratings, forecasted recovery, its intent to sell or the likelihood that it would be required to sell the investment before its anticipated recovery in market value and the probability that the scheduled cash payments will continue to be made. When the Company concludes that an other-than-temporary impairment has occurred, the Company assesses whether it intends to sell the security or if it is more likely than not that it will be required to sell the security before recovery. If either of these two conditions is met, the Company recognizes a charge in earnings equal to the entire difference between the security's amortized cost basis and its fair value. If the Company does not intend to sell a security or it is not more likely than not that it will be required to sell the security before recovery, the unrealized loss is separated into an

**Silicon Laboratories Inc.**
**Notes to Consolidated Financial Statements (Continued)**
**January 2, 2010**

**2. Significant Accounting Policies (Continued)**

amount representing the credit loss, which is recognized in earnings, and the amount related to all other factors, which is recorded in accumulated other comprehensive loss.

*Derivative Financial Instruments*

The Company uses derivative financial instruments to manage exposures to the variability of interest rates used to calculate base rents for its corporate headquarters leases. The Company's objective is to offset increases and decreases in expenses resulting from changes in interest rates with losses and gains on the derivative contracts, thereby reducing volatility of earnings. The Company does not use derivative contracts for speculative purposes. The effective portion of the gain or loss on interest rate swaps is recorded in accumulated other comprehensive loss as a separate component of stockholders' equity and is subsequently recognized in earnings when the hedged exposure affects earnings. Cash flows from derivatives are classified as cash flows from operating activities in the Consolidated Statement of Cash Flows.

*Inventories*

Inventories are stated at the lower of cost, determined using the first-in, first-out method, or market.

*Property and Equipment*

Property and equipment are stated at cost, net of accumulated depreciation. Depreciation is computed using the straight-line method over the useful lives of the assets ranging from three to five years. Leasehold improvements are depreciated over the contractual lease period or their useful life, whichever is shorter.

*Long-Lived Assets*

Purchased intangible assets are stated at cost, net of accumulated amortization, and are amortized using the straight-line method over their estimated useful lives, ranging from four to twelve years.

Long-lived assets "held and used" by the Company are reviewed for impairment whenever events or changes in circumstances indicate that their net book value may not be recoverable. When such factors and circumstances exist, the Company compares the projected undiscounted future cash flows associated with the related asset or group of assets over their estimated useful lives, against their respective carrying amounts. Impairment, if any, is based on the excess of the carrying amount over the fair value of those assets and is recorded in the period in which the determination was made.

The carrying value of goodwill is reviewed at least annually by the Company for possible impairment. The goodwill impairment test is a two-step process. The first step of the impairment analysis compares the fair value of the company or reporting unit to the net book value of the company or reporting unit. In determining fair value, several valuation methodologies are allowed, although quoted market prices are the best evidence of fair value. If the results of the first step demonstrate that the net book value is greater than the fair value, the Company must proceed to step two of the analysis. Step two of the analysis compares the implied fair value of goodwill to its carrying amount. If the carrying amount of goodwill exceeds its implied fair value, an impairment loss is recognized equal

**Silicon Laboratories Inc.**
**Notes to Consolidated Financial Statements (Continued)**
**January 2, 2010**

**2. Significant Accounting Policies (Continued)**

to that excess. The Company tests goodwill for impairment annually as of the first day of its fourth fiscal quarter and in interim periods if events occur that would indicate that the carrying value of goodwill may be impaired.

*Revenue Recognition*

Revenues are generated almost exclusively by sales of the Company's ICs. The Company recognizes revenue when all of the following criteria are met: 1) there is persuasive evidence that an arrangement exists, 2) delivery of goods has occurred, 3) the sales price is fixed or determinable, and 4) collectibility is reasonably assured. Generally, revenue from product sales to direct customers and contract manufacturers is recognized upon shipment.

A portion of the Company's sales are made to distributors under agreements allowing certain rights of return and price protection related to the final selling price to the end customers. Accordingly, the Company defers revenue and cost of revenue on such sales until the distributors sell the product to the end customers. The net balance of deferred revenue less deferred cost of revenue associated with inventory shipped to a distributor but not yet sold to an end customer is recorded in the "deferred income on shipments to distributors" liability on the Consolidated Balance Sheet. Such net deferred income balance reflects the Company's estimate of the impact of rights of return and price protection.

*Shipping and Handling*

Shipping and handling costs are classified as a component of cost of revenues in the Consolidated Statements of Income.

*Stock-Based Compensation*

The Company has stock-based compensation plans, which are more fully described in Note 13, *Stock-Based Compensation*. The Company accounts for those plans using a fair-value method and recognizes the expense in its Consolidated Statement of Income.

*Advertising*

Advertising costs are expensed as incurred. Advertising expenses were $1.5 million, $1.7 million and $1.1 million and in fiscal 2009, 2008 and 2007, respectively.

*Income Taxes*

The Company accounts for income taxes using the asset and liability method whereby deferred tax asset and liability account balances are determined based on differences between financial reporting and the tax bases of assets and liabilities and are measured using the enacted tax laws and related rates that will be in effect when the differences are expected to reverse. These differences result in deferred tax assets and liabilities, which are included in the Company's Consolidated Balance Sheet. The Company then assesses the likelihood that the deferred tax assets will be recovered from future taxable income. A valuation allowance is established against deferred tax assets to the extent the Company believes that recovery is not likely based on the level of historical taxable income and projections for future taxable income over the periods in which the temporary differences are deductible.

**Silicon Laboratories Inc.**
**Notes to Consolidated Financial Statements (Continued)**
**January 2, 2010**

**2. Significant Accounting Policies (Continued)**

Uncertain tax positions must meet a more-likely-than-not threshold to be recognized in the financial statements and the tax benefits recognized are measured based on the largest benefit that has a greater than 50% likelihood of being realized upon final settlement. See further discussion in Note 16, *Income Taxes*.

*Recent Accounting Pronouncements*

In April 2009, the Financial Accounting Standards Board (FASB) issued the following:

FASB Accounting Standards Codification (ASC) 820-10-65, formerly FASB Staff Position (FSP) FAS No. 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly*, provides additional guidance for estimating fair value when the volume and level of activity for the asset or liability have significantly decreased. This ASC also includes guidance on identifying circumstances that indicate a transaction is not orderly.

FASB ASC 320-10-65, formerly FSP No. FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments*, amends the other-than-temporary impairment guidance in U.S. GAAP for debt securities to make the guidance more operational and to improve the presentation and disclosure of other-than-temporary impairments on debt and equity securities in the financial statements.

FASB ASC 825-10-65, formerly FSP No. FAS 107-1 and APB 28-1, *Interim Disclosures about Fair Value of Financial Instruments*, requires disclosures about fair value of financial instruments for interim reporting periods of publicly traded companies as well as in annual financial statements.

These ASCs are effective for reporting periods ending after June 15, 2009 and were adopted by the Company on April 5, 2009. The adoption of the ASCs did not have a material impact on the Company's financial statements.

In June 2008, the FASB issued FASB ASC 260-10-45, formerly FSP Emerging Issues Task Force (EITF) 03-6-1, *Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities*. ASC 260-10-45 provides that unvested share-based payment awards that contain nonforfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and shall be included in the computation of earnings per share pursuant to the two-class method described in FASB ASC 260, *Earnings per Share*. ASC 260-10-45 is effective for financial statements issued for fiscal years beginning after December 15, 2008 and interim periods within those years on a retrospective basis. The Company adopted ASC 260-10-45 at the beginning of fiscal 2009. The adoption did not have a material impact on the Company's financial statements.

**3. Discontinued Operation**

In March 2007, the Company sold its Aero product lines to NXP for $285 million in cash, plus additional earn-out potential of up to an aggregate of $65 million over the next three years. To date, no additional earn-out has been recognized from this transaction.

**Silicon Laboratories Inc.**
**Notes to Consolidated Financial Statements (Continued)**
**January 2, 2010**

**3. Discontinued Operation (Continued)**

The financial results of the sold product lines have been presented as discontinued operations in the Consolidated Financial Statements. The following summarizes results from the discontinued operations (in thousands, except per share data):

| | Year Ended December 29, 2007 |
|---|---|
| Revenues | $ 46,310 |
| Costs of revenues and operating expenses | 43,810 |
| | 2,500 |
| Gain on sale of discontinued operations | 224,887 |
| Income from discontinued operations before income taxes | 227,387 |
| Provision for income taxes | 62,238 |
| Income from discontinued operations, net of income taxes | $ 165,149 |
| Income from discontinued operations per common share: | |
| Basic | $ 3.02 |
| Diluted | $ 2.94 |
| Weighted-average common shares outstanding: | |
| Basic | 54,826 |
| Diluted | 56,321 |

During fiscal 2007, the Company made $45.0 million of estimated tax payments due primarily to the gain on the sale of its Aero product lines and received $26.2 million for the exercise of stock options from employees who were hired by NXP associated with the sale of the Aero products.

*Continuing Involvement*

In connection with the closing of the sale, the Company entered into certain ancillary agreements with NXP, including a Transition Services Agreement ("TSA") and an Intellectual Property License Agreement ("IPLA"). Through the TSA, the Company subleased certain premises to NXP and provided various temporary support services, such as IT support services. Such services were provided for approximately six months from the closing date and are no longer being provided. The fees for these services were generally equivalent to the Company's cost and were approximately $3.9 million in fiscal 2007. Through the IPLA, the Company granted NXP a license with respect to retained intellectual property and NXP granted a license to the Company with respect to transferred intellectual property. However, these cross-license agreements do not involve the receipt or payment of any royalties and therefore are not considered to be a component of continuing involvement.

**Silicon Laboratories Inc.**
**Notes to Consolidated Financial Statements (Continued)**
**January 2, 2010**

## 4. Earnings Per Share

The following table sets forth the computation of basic and diluted earnings per share from continuing operations (in thousands, except per share data):

| | Year Ended | | |
|---|---|---|---|
| | January 2, 2010 | January 3, 2009 | December 29, 2007 |
| Income from continuing operations | $ 73,092 | $ 32,935 | $ 39,687 |
| Shares used in computing basic earnings per share | 45,023 | 48,109 | 54,826 |
| Effect of dilutive securities: | | | |
| Stock options and awards | 1,519 | 880 | 1,495 |
| Shares used in computing diluted earnings per share | 46,542 | 48,989 | 56,321 |
| Income from continuing operations | | | |
| Basic earnings per share | $ 1.62 | $ 0.68 | $ 0.72 |
| Diluted earnings per share | $ 1.57 | $ 0.67 | $ 0.70 |

Approximately 2.1 million, 4.2 million and 4.0 million weighted-average dilutive potential shares of common stock have been excluded from the diluted earnings per share calculation for fiscal years ended January 2, 2010, January 3, 2009 and December 29, 2007, respectively, as they were anti-dilutive.

## 5. Cash, Cash Equivalents and Investments

The Company's cash equivalents and short-term investments consist primarily of money market funds, U.S. government agency bonds and discount notes, corporate bonds, municipal bonds, U.S. Treasury bills, U.S. government bonds, commercial paper, international government bonds and auction-rate securities purchased through UBS ("UBS auction-rate securities"). The Company's long-term investments consist of non-UBS auction-rate securities. Early in fiscal 2008, auctions for many of the Company's auction-rate securities failed because sell orders exceeded buy orders. As of January 2, 2010, the Company held $51.3 million par value auction-rate securities, all of which have experienced failed auctions. The underlying assets of the securities consisted of student loans and municipal bonds, of which $47.3 million were guaranteed by the U.S. government and the remaining $4.0 million were privately insured. As of January 2, 2010, $40.3 million of the auction-rate securities had credit ratings of AAA, $4.0 million had credit ratings of AA and $7.0 million had a credit rating of BBB. These securities had contractual maturity dates ranging from 2025 to 2046 and with current yields of 0.46% to 2.79% per year at January 2, 2010. The Company is receiving the underlying cash flows on all of its auction-rate securities. The principal amounts associated with failed auctions are not expected to be accessible until a successful auction occurs, the issuer redeems the securities, a buyer is found outside of the auction process or the underlying securities mature. The Company is unable to predict if these funds will become available before their maturity dates.

**Silicon Laboratories Inc.**
**Notes to Consolidated Financial Statements (Continued)**
**January 2, 2010**

**5. Cash, Cash Equivalents and Investments (Continued)**

In November 2008, the Company entered into an agreement with UBS AG, which provides the Company certain rights to sell to UBS the auction-rate securities which were purchased through them. As of January 2, 2010, the Company held $24.0 million par value auction-rate securities purchased from UBS. The Company has the option to sell these securities to UBS at par value from June 30, 2010 through July 2, 2012. UBS, at its discretion, may purchase or sell these securities on the Company's behalf at any time provided the Company receives par value for the securities sold. The issuers of the auction-rate securities continue to have the right to redeem the securities at their discretion. The agreement allows for the continuation of the accrual and payment of interest due on the securities. The agreement also provides the Company with access to loans of up to 75% of the market value of the unredeemed securities until June 30, 2010. These loans would carry interest rates which would be consistent with the interest income on the related auction-rate securities. As of January 2, 2010, the Company had no loans outstanding under this agreement.

The Company's right to sell the auction-rate securities to UBS commencing June 30, 2010 represents a put option for a payment equal to the par value of the auction-rate securities. As the put option is non-transferable and cannot be attached to the auction-rate securities if they are sold to another entity other than UBS, it represents a freestanding instrument between the Company and UBS. The Company elected to record the put option at fair value. During fiscal 2008, the Company recorded a gain of $5.0 million representing (a) the initial fair value of the put option, and (b) the changes in the fair value of the put option from November to the end of the year. The Company has classified the UBS auction-rate securities as trading securities and, accordingly, recognizes changes in fair value in earnings. During fiscal 2008, the Company recorded a loss of $5.1 million representing (a) the transfer of the UBS auction-rate securities from available-for-sale to trading securities and, accordingly, recognizing the unrealized losses previously recorded in accumulated other comprehensive loss in earnings at the election date, and (b) the subsequent changes in fair value from the election date to the end of the year. Both the gain from recording the put option at fair value and the loss due to the transfer from available-for-sale to trading securities, as well as subsequent fair value adjustments, were recorded in "other income (expense), net". Adjustments to the fair values of the put option and the trading securities generally offset each other. The Company intends to exercise its option to sell its UBS auction-rate securities to UBS on June 30, 2010 and has therefore classified both the UBS auction-rate securities and the related put option as short-term investments as of January 2, 2010.

The Company does not expect to need access to the capital represented by any of its auction-rate securities prior to their maturities. The Company does not intend to sell, and believes it is not more likely than not that it will be required to sell, its non-UBS auction-rate securities before their anticipated recovery in market value or final settlement at the underlying par value. The Company believes that the credit ratings and credit support of the security issuers indicate that they have the ability to settle the securities at par value. As such, the Company has determined that no material other-than-temporary impairment losses existed as of January 2, 2010.

**Silicon Laboratories Inc.**
**Notes to Consolidated Financial Statements (Continued)**
**January 2, 2010**

**5. Cash, Cash Equivalents and Investments (Continued)**

The Company's cash, cash equivalents and investments consist of the following (in thousands):

| | January 2, 2010 | | | |
|---|---|---|---|---|
| | Cost | Gross Unrealized Losses | Gross Unrealized Gains | Fair Value |
| **Cash and Cash Equivalents:** | | | | |
| Cash on hand | $ 21,622 | | | $ 21,622 |
| Available-for-sale securities: | | | | |
| Money market funds | 167,139 | $ | $ | 167,139 |
| U.S. Treasury bills | 5,000 | | | 5,000 |
| U.S. government agency | 2,000 | (24) | | 1,976 |
| Total available-for-sale securities | 174,139 | (24) | | 174,115 |
| Total cash and cash equivalents | $ 195,761 | $ (24) | $ | $ 195,737 |
| **Short-term Investments:** | | | | |
| Available-for-sale securities: | | | | |
| Corporate bonds | $ 74,431 | $ (133) | $ 188 | $ 74,486 |
| U.S. government agency | 41,790 | (1) | 32 | 41,821 |
| Municipal bonds | 37,401 | (3) | 132 | 37,530 |
| U.S. Treasury bills | 21,488 | | 7 | 21,495 |
| International government bonds | 12,467 | (10) | 6 | 12,463 |
| Commercial paper | 2,699 | | | 2,699 |
| Total available-for-sale securities | $ 190,276 | $ (147) | $ 365 | 190,494 |
| Trading securities: | | | | |
| Auction rate securities and put option | | | | 23,992 |
| Total short-term investments | | | | $ 214,486 |
| **Long-term Investments:** | | | | |
| Available-for-sale securities: | | | | |
| Auction rate securities | $ 27,325 | $ (2,649) | $ | $ 24,676 |
| Total long-term investments | $ 27,325 | $ (2,649) | $ | $ 24,676 |

**Silicon Laboratories Inc.**
**Notes to Consolidated Financial Statements (Continued)**
**January 2, 2010**

**5. Cash, Cash Equivalents and Investments (Continued)**

| | January 3, 2009 | | | |
|---|---|---|---|---|
| | Cost | Gross Unrealized Losses | Gross Unrealized Gains | Fair Value |
| **Cash and Cash Equivalents:** | | | | |
| Cash on hand | $ 21,544 | | | $ 21,544 |
| Available-for-sale securities: | | | | |
| Money market funds | 150,728 | $ | $ | 150,728 |
| Total cash and cash equivalents | $ 172,272 | $ | $ | $ 172,272 |
| **Short-term Investments:** | | | | |
| Available-for-sale securities: | | | | |
| Municipal bonds | $ 88,907 | $ (1) | $ 504 | $ 89,410 |
| U.S. government agency | 10,001 | | 56 | 10,057 |
| | $ 98,908 | $ (1) | $ 560 | 99,467 |
| Trading securities: | | | | |
| Auction rate securities | | | | 1,800 |
| Total short-term investments | | | | $ 101,267 |
| **Long-term Investments:** | | | | |
| Available-for-sale securities: | | | | |
| Auction-rate securities | $ 30,000 | $ (4,260) | $ | $ 25,740 |
| Trading securities: | | | | |
| Auction rate securities and put option | | | | 26,081 |
| Total long-term investments | | | | $ 51,821 |

The available-for-sale investments that were in a continuous unrealized loss position as of January 2, 2010, aggregated by length of time that individual securities have been in a continuous loss position, were as follows (in thousands):

| | Less Than 12 Months | | 12 Months or Greater | | Total | |
|---|---|---|---|---|---|---|
| | Fair Value | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses |
| Corporate bonds | $ 39,513 | $ (133) | $ | $ | $ 39,513 | $ (133) |
| Auction rate securities | | | 24,676 | (2,649) | 24,676 | (2,649) |
| International government bonds | 5,213 | (10) | | | 5,213 | (10) |
| U.S. government agency | 4,978 | (25) | | | 4,978 | (25) |
| Municipal bonds | 1,643 | (3) | | | 1,643 | (3) |
| | $ 51,347 | $ (171) | $ 24,676 | $ (2,649) | $ 76,023 | $ (2,820) |

All of the Company's available-for-sale investments with gross unrealized losses as of January 3, 2009 had been in a continuous loss position for less than 12 months. The gross unrealized losses as of

**Silicon Laboratories Inc.**
**Notes to Consolidated Financial Statements (Continued)**
**January 2, 2010**

**5. Cash, Cash Equivalents and Investments (Continued)**

January 2, 2010 and January 3, 2009 were due primarily to the illiquidity of the Company's auction-rate securities and, to a lesser extent, to changes in market interest rates.

The following summarizes the contractual underlying maturities of the Company's available-for-sale investments at January 2, 2010 (in thousands):

| | Cost | Fair Value |
|---|---|---|
| Due in one year or less | $ 282,067 | $ 282,263 |
| Due after one year through three years | 82,348 | 82,346 |
| Due after ten years | 27,325 | 24,676 |
| | $ 391,740 | $ 389,285 |

In addition, the Company has made equity investments in non-publicly traded companies that it accounts for under the cost method. The Company periodically reviews these investments for other-than-temporary declines in fair value based on the specific identification method and writes down investments to their fair values when it determines that an other-than-temporary decline has occurred.

**6. Derivative Financial Instruments**

The Company is exposed to interest rate fluctuations in the normal course of its business, including through its corporate headquarters leases. The base rents for these leases are calculated using a variable interest rate based on the three-month LIBOR. The Company has entered into interest rate swap agreements with notional values of $44.3 million and $50.1 million and, effectively, fixed the rent payment amounts on these leases through March 2011 and March 2013, respectively. The interest rate swap agreements are designated and qualify as cash flow hedges.

The Company estimates the fair values of derivatives based on quoted prices and market observable data of similar instruments. If the lease agreements or the interest rate swap agreements are terminated prior to maturity, the fair value of the interest rate swaps recorded in accumulated other comprehensive loss may be recognized in the Consolidated Statement of Income based on an assessment of the agreements at the time of termination. The Company did not discontinue any cash flow hedges in any of the periods presented.

The Company measures the effectiveness of its cash flow hedges by comparing the change in fair value of the hedged item with the change in fair value of the interest rate swap. The Company recognizes ineffective portions of the hedge, as well as amounts not included in the assessment of effectiveness, in the Consolidated Statement of Income. As of January 2, 2010, no portions of the gains or losses from the hedging instruments were excluded from the assessment of effectiveness. There was no hedge ineffectiveness for any of the periods presented.

The Company's derivative financial instruments consisted of the following (in thousands):

| | January 2, 2010 | |
|---|---|---|
| | Balance Sheet Location | Fair Value |
| Interest rate swaps | Long-term obligations and other liabilities | $ 4,491 |

**Silicon Laboratories Inc.**
**Notes to Consolidated Financial Statements (Continued)**
**January 2, 2010**

### 6. Derivative Financial Instruments (Continued)

The before-tax effect of derivative instruments in cash flow hedging relationships was as follows (in thousands):

| | Loss Recognized in OCI on Derivatives (Effective Portion) during the Year Ended | | Location of Loss Reclassified into Income | Loss Reclassified from Accumulated OCI into Income (Effective Portion) during the Year Ended | |
|---|---|---|---|---|---|
| | January 2, 2010 | January 3, 2009 | | January 2, 2010 | January 3, 2009 |
| Interest rate swaps | $ (1,681) | $ (5,615) | Rent expense | $ (2,792) | $ (12) |

The Company expects to reclassify $3.0 million of its interest rate swap losses included in accumulated other comprehensive loss as of January 2, 2010 into earnings in the next 12 months, which is offset by lower rent payments.

The Company's interest rate swap agreements contain provisions that require it to maintain unencumbered cash and highly-rated short-term investments of at least $150 million. If the Company's unencumbered cash and highly-rated short-term investments are less than $150 million, it would be required to post collateral with the counterparty in the amount of the fair value of the interest rate swap agreements in net liability positions. Both of the Company's interest rate swaps were in a net liability position at January 2, 2010. No collateral has been posted with the counterparties as of January 2, 2010.

### 7. Fair Value of Financial Instruments

The following summarizes the valuation of the Company's financial instruments (in thousands). The tables do not include either cash on hand or assets and liabilities that are measured at historical cost or any basis other than fair value.

| | Fair Value Measurements at January 2, 2010 Using | | | |
|---|---|---|---|---|
| Description | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | Total |
| Assets | | | | |
| Cash equivalents | $ 174,115 | $ | $ | $ 174,115 |
| Short-term investments(1) | 190,494 | | 23,992 | 214,486 |
| Long-term investments(2) | | | 24,676 | 24,676 |
| | $ 364,609 | $ | $ 48,668 | $ 413,277 |
| Liabilities | | | | |
| Derivative instruments | $ | $ 4,491 | $ | $ 4,491 |
| | $ | $ 4,491 | $ | $ 4,491 |

(1)
Included in the Company's short-term investments are $74.5 million of corporate debt securities, $41.8 million of U.S. government agency debt securities, $37.5 million of municipal debt securities, $21.5 million of U.S. Treasury bills, $12.5 million of international government debt securities, $2.7 million of commercial paper and $20.9 million of UBS auction-rate securities classified as trading together with $3.1 million for a put option.

(2)
The Company's long-term investments consist entirely of available-for-sale auction-rate securities.

**Silicon Laboratories Inc.**
**Notes to Consolidated Financial Statements (Continued)**
**January 2, 2010**

**7. Fair Value of Financial Instruments (Continued)**

| | Fair Value Measurements at January 3, 2009 Using | | | |
|---|---|---|---|---|
| **Description** | **Quoted Prices in Active Markets for Identical Assets (Level 1)** | **Significant Other Observable Inputs (Level 2)** | **Significant Unobservable Inputs (Level 3)** | **Total** |
| Assets | | | | |
| Cash equivalents | $ 150,728 | $ | $ | $ 150,728 |
| Short-term investments(1) | 101,267 | | | 101,267 |
| Long-term investments(2) | | | 51,821 | 51,821 |
| | $ 251,995 | $ | $ 51,821 | $ 303,816 |
| Liabilities | | | | |
| Derivative instruments | $ | $ 5,603 | $ | $ 5,603 |
| | $ | $ 5,603 | $ | $ 5,603 |

(1)
Included in the Company's short term investments are $89.4 million of municipal debt securities, $10.1 million of U.S. government agency debt securities and $1.8 million of auction-rate securities which settled shortly after year end.

(2)
Included in the Company's long term investments are $25.7 million of available-for-sale auction-rate securities, $21.1 million of auction-rate securities classified as trading and $5.0 million for a put option.

The Company's cash equivalents and short-term investments (other than its UBS auction-rate securities and put option) are valued using quoted prices and other relevant information generated by market transactions involving identical assets. The Company's auction-rate securities and put option are valued using a discounted cash flow model. The assumptions used in preparing the discounted cash flow model include estimates for interest rates, amount of cash flows, expected holding periods of the securities, a discount to reflect the Company's inability to liquidate the securities and counterparty risk. The Company's derivative instruments are valued using quoted prices and market observable data of similar instruments.

**Silicon Laboratories Inc.**
**Notes to Consolidated Financial Statements (Continued)**
**January 2, 2010**

**7. Fair Value of Financial Instruments (Continued)**

The following summarizes the activity in Level 3 financial instruments for the years ended January 2, 2010 and January 3, 2009 (in thousands):

| | Auction Rate Securities | Put Option | Total |
|---|---|---|---|
| Balance at January 3, 2009 | $ 46,859 | $ 4,962 | $ 51,821 |
| Net purchases, sales, issuances and settlements | (4,574) | (301) | (4,875) |
| Unrealized gains (losses) | 1,855 | | 1,855 |
| Net recognized gains (losses) | 1,435 | (1,568) | (133) |
| Balance at January 2, 2010 | $ 45,575 | $ 3,093 | $ 48,668 |
| Gain (loss) for period included in earnings attributable to the Level 3 financial instruments still held at January 2, 2010 related to: | | | |
| Trading securities | $ 1,435 | $ | $ 1,435 |
| Fair value of the put option | | (1,568) | (1,568) |
| | $ 1,435 | $ (1,568) | $ (133) |

| | Auction Rate Securities | Put Option | Total |
|---|---|---|---|
| Balance at December 29, 2007 | $ | $ | $ |
| Net transfers into Level 3(1) | 68,800 | | 68,800 |
| Net purchases, sales, issuances and settlements | (12,600) | 2,689 | (9,911) |
| Unrealized losses | (4,260) | | (4,260) |
| Net recognized gains (losses) | (5,081) | 2,273 | (2,808) |
| Balance at January 3, 2009 | $ 46,859 | $ 4,962 | $ 51,821 |
| Gain (loss) for period included in earnings attributable to the Level 3 financial instruments still held at January 3, 2009 related to: | | | |
| Trading securities | $ (5,081) | $ | $ (5,081) |
| Fair value of the put option | | 4,962 | 4,962 |
| | $ (5,081) | $ 4,962 | $ (119) |

(1)
Early in fiscal 2008, quoted prices for the Company's long-term investments were no longer observable. As such, the Company changed its fair value measurement methodology from quoted prices in active markets to a cash flow model. Accordingly, these securities were reclassified from Level 1 to Level 3. In November 2008, the Company recorded a put option to sell a portion of its auction-rate securities, which resulted in a gain recorded in earnings. The gain was offset by the reclassification of unrealized losses on

the associated securities to realized losses recorded in earnings. Both the gain from recording the put option at fair value and the loss due to the reclassification of unrealized losses were recorded in "other income (expense), net".

The Company's other financial instruments, including cash, accounts receivable and accounts payable, are recorded at amounts that approximate their fair values due to their short maturities.

**Silicon Laboratories Inc.**
**Notes to Consolidated Financial Statements (Continued)**
**January 2, 2010**

## 8. Balance Sheet Details

Balance sheet details consist of the following (in thousands):

*Inventories*

| | January 2, 2010 | January 3, 2009 |
|---|---|---|
| Work in progress | $ 24,642 | $ 23,474 |
| Finished goods | 6,870 | 4,819 |
| | $ 31,512 | $ 28,293 |

*Property and Equipment*

| | January 2, 2010 | January 3, 2009 |
|---|---|---|
| Equipment | $ 36,232 | $ 34,838 |
| Computers and purchased software | 39,296 | 39,171 |
| Furniture and fixtures | 3,174 | 3,167 |
| Leasehold improvements | 19,029 | 15,703 |
| | 97,731 | 92,879 |
| Accumulated depreciation | (69,946) | (62,383) |
| | $ 27,785 | $ 30,496 |

*Accrued Expenses*

| | January 2, 2010 | January 3, 2009 |
|---|---|---|
| Accrued compensation and benefits | $ 15,757 | $ 11,489 |
| Escrow withheld in acquisitions | | 4,425 |
| Accrued price protection credits | 2,957 | 4,360 |
| Other | 6,685 | 8,845 |
| | $ 25,399 | $ 29,119 |

*Long-term Obligations and Other Liabilities*

| | January 2, 2010 | January 3, 2009 |
|---|---|---|
| Unrecognized tax benefits (including interest) | $ 12,025 | $ 34,169 |
| Other | 12,378 | 14,620 |
| | $ 24,403 | $ 48,789 |

**Silicon Laboratories Inc.**
**Notes to Consolidated Financial Statements (Continued)**
**January 2, 2010**

## 9. Risks and Uncertainties

*Financial Instruments*

Financial instruments that potentially subject the Company to significant concentrations of credit risk consist primarily of cash equivalents, investments, accounts receivable and derivatives. The Company places its cash equivalents and investments primarily in U.S. government agency bonds and discount notes, corporate bonds, municipal bonds, U.S. Treasury bills, commercial paper, international government bonds and auction-rate securities. Concentrations of credit risk with respect to accounts receivable are primarily due to customers with large outstanding balances. The Company's customers that accounted for greater than 10% of accounts receivable consist of the following:

| | January 2, 2010 | January 3, 2009 |
|---|---|---|
| Edom Technology | 33% | 28% |
| Avnet | 14% | ** |
| Flextronics | ** | 12% |

** Less than 10% of accounts receivable

The Company performs periodic credit evaluations of its customers' financial condition and generally requires no collateral from its customers. The Company provides an allowance for potential credit losses based upon the expected collectibility of such receivables. Losses have not been significant for any of the periods presented.

*Suppliers*

A significant portion of the Company's products are fabricated by Taiwan Semiconductor Manufacturing Co. (TSMC) or its affiliates. The inability of TSMC to deliver wafers to the Company on a timely basis could impact the production of the Company's products for a substantial period of time, which could have a material adverse effect on the Company's business, financial condition and results of operations.

*Customers*

The Company sells directly to end customers, distributors and contract manufacturers. Although the Company actually sells the products to, and is paid by, distributors and contract manufacturers, the Company refers to the end customer as its customer. None of the Company's contract manufacturers accounted for greater than 10% of revenue during fiscal 2009, 2008 or 2007. The Company's end customers and distributors that accounted for greater than 10% of revenue consists of the following:

| | Year Ended | | |
|---|---|---|---|
| | January 2, 2010 | January 3, 2009 | December 29, 2007 |
| *End Customers* | | | |
| Samsung | 16% | ** | ** |
| *Distributors* | | | |
| Edom Technology | 27% | 31% | 36% |
| Avnet | 10% | ** | 10% |

** Less than 10% of revenue

**Silicon Laboratories Inc.**
**Notes to Consolidated Financial Statements (Continued)**
**January 2, 2010**

## 10. Acquisitions

*Integration Associates*

In July 2008, the Company completed its acquisition of Integration Associates, a privately held company that designed and developed silicon solutions for wireless, wireline and power system management applications. The Company acquired Integration Associates for approximately $87.1 million, including $80.6 million in cash and approximately 202,000 shares of the Company's common stock valued at $6.5 million on the closing date. Of such consideration, $9.0 million in cash was deposited in escrow as security for breaches of representations and warranties and certain other expressly enumerated matters.

The acquisition was recorded using the purchase method of accounting and accordingly, the results of Integration Associates' operations are included in the Company's consolidated results of operations beginning with the date of the acquisition. Pro forma financial information has not been presented since the effect of the acquisition was not material. The Company believes that the acquisition enables the Company to address new product vectors, accelerates its entry into certain markets and further scales the Company's engineering team. These factors contributed to a purchase price that was in excess of the fair value of the net assets acquired and, as a result, the Company recorded goodwill. The goodwill is not deductible for tax purposes. The purchase price was allocated as follows (in thousands):

| | Amount | Weighted-Average Amortization Period (Years) |
|---|---|---|
| Intangible assets: | | |
| Core and developed technology | $ 36,270 | 9.7 |
| Customer relationships | 1,080 | 10.0 |
| In-process research and development | 10,250 | |
| | 47,600 | |
| Cash and cash equivalents | 2,644 | |
| Accounts receivable | 4,879 | |
| Inventories | 5,925 | |
| Other current assets | 3,604 | |
| Goodwill | 32,013 | |
| Other non-current assets | 4,688 | |
| Accounts payable | (2,833) | |
| Other current liabilities | (4,471) | |
| Deferred tax liabilities | (6,908) | |
| Total purchase price | $ 87,141 | |

**Silicon Laboratories Inc.**
**Notes to Consolidated Financial Statements (Continued)**
**January 2, 2010**

**10. Acquisitions (Continued)**

In-process research and development (IPR&D) represents acquired technology that had not achieved technological feasibility as of the acquisition closing date and that had no alternative future use. These costs were expensed on the date of acquisition. The fair value of each project was determined using the income approach. The discount rate applicable to the cash flows was 20%. This rate reflects the weighted-average cost of capital and the risks inherent in the development process. The IPR&D recorded in connection with the acquisition consisted of the following (in thousands):

| Projects | Fair Value |
|---|---|
| Radio transmitters and transceivers | $ 7,740 |
| Optoelectronic | 2,020 |
| Power | 490 |
| | $ 10,250 |

The radio transmitters and transceivers projects enable the delivery of data over proprietary, short range wireless links. The optoelectronic projects are used for infrared data communications and proximity sensing. The power projects enable AC-DC conversion in power supply systems.

*SourceCore*

In October 2007, the Company completed its acquisition of substantially all of the assets of SourceCore, a privately held mixed-signal design company for approximately $10.6 million, which includes direct acquisition costs. The acquisition was recorded using the purchase method of accounting and accordingly, the results of SourceCore's operations are included in the Company's consolidated results of operations from the date of the acquisition. Through the acquisition, the Company acquired RF designers as well as an applications and software team in close proximity to our customer base in China. These factors contributed to a purchase price that was in excess of the fair value of the net assets acquired and, as a result, the Company recorded goodwill. None of the goodwill is deductible for tax purposes. The purchase price was allocated as follows: goodwill $7.6 million; intangible assets $2.6 million; and net tangible assets $0.4 million.

**11. Goodwill and Other Intangible Assets**

The gross carrying amount and accumulated amortization of goodwill and other intangible assets are as follows (in thousands):

| | Weighted-Average Amortization Period (Years) | January 2, 2010 Gross Amount | January 2, 2010 Accumulated Amortization | January 3, 2009 Gross Amount | January 3, 2009 Accumulated Amortization |
|---|---|---|---|---|---|
| Goodwill | Not amortized | $ 105,109 | $ | $ 105,515 | $ |
| Amortized intangible assets: | | | | | |
| Core & developed technology | 9.3 | $ 54,920 | $ (16,024) | $ 55,220 | $ (10,132) |
| Customer relationships | 6.6 | 3,380 | (1,188) | 5,480 | (2,389) |
| Patents | 7.0 | 4,638 | (3,921) | 4,663 | (3,281) |
| Internal use software | 7.0 | 600 | (519) | 600 | (433) |
| Total | 9.0 | $ 63,538 | $ (21,652) | $ 65,963 | $ (16,235) |

**Silicon Laboratories Inc.**
**Notes to Consolidated Financial Statements (Continued)**
**January 2, 2010**

### 11. Goodwill and Other Intangible Assets (Continued)

Amortization expense related to intangible assets for fiscal 2009, 2008 and 2007 was $7.8 million, $5.7 million, and $4.3 million, respectively. Fully amortized assets are written off against accumulated amortization. The estimated aggregate amortization expense for intangible assets for each of the five succeeding fiscal years is as follows (in thousands):

| Fiscal Year | Amount |
|---|---|
| 2010 | $ 7,205 |
| 2011 | 6,888 |
| 2012 | 6,427 |
| 2013 | 5,042 |
| 2014 | 4,259 |

### 12. Stockholders' Equity

*Common Stock*

The Company issued 1.8 million shares of common stock during fiscal 2009. Approximately 189 thousand shares were withheld by the Company during fiscal 2009 to satisfy employee tax obligations for the vesting of certain stock grants made under the Company's stock incentive plans.

*Share Repurchase Program*

In October 2009, the Company's Board of Directors authorized a program to repurchase up to $150 million of the Company's common stock through 2010. The program allows for repurchases to be made in the open market or in private transactions, including structured or accelerated transactions, subject to applicable legal requirements and market conditions. The Company's most recent prior repurchase program, which was announced in October 2008 and authorized the repurchase of up to $100 million of the Company's common stock over a 12-month period, was completed in November 2009. The Company repurchased 0.6 million shares, 9.4 million shares and 4.4 million shares of its common stock for $20.2 million, $280.3 million and $163.2 million during fiscal 2009, 2008 and 2007, respectively.

*Accumulated Other Comprehensive Loss*

The components of accumulated other comprehensive loss, net of taxes, were as follows (in thousands):

| | Unrealized Losses on Cash Flow Hedges | Net Unrealized Losses on Available-For-Sale Securities | Total |
|---|---|---|---|
| Balance at January 3, 2009 | $ (3,642) | $ (2,406) | $ (6,048) |
| Change associated with current period transactions, net of tax | (1,092) | 969 | (123) |
| Amount reclassified into earnings, net of tax | 1,815 | | 1,815 |
| Balance at January 2, 2010 | $ (2,919) | $ (1,437) | $ (4,356) |

**Silicon Laboratories Inc.**
**Notes to Consolidated Financial Statements (Continued)**
**January 2, 2010**

## 13. Stock-Based Compensation

In fiscal 2009, the stockholders of the Company approved the 2009 Stock Incentive Plan (the "2009 Plan") and the 2009 Employee Stock Purchase Plan (the "2009 Purchase Plan"). The 2009 Plan is currently effective, and no further grants will be issued under the Company's 2000 Stock Incentive Plan (the "2000 Plan") as of the effective date of the 2009 Plan. The 2009 Purchase Plan will become effective upon the termination of the existing Employee Stock Purchase Plan (the "Purchase Plan"), on April 30, 2010.

The shares issuable under the 2000 Plan and Purchase Plan automatically increased on the first stock market trading day of each calendar year. The amount of shares reserved for the 2000 Plan increased by 2.2 million shares, and for the Purchase Plan increased by 220 thousand shares on January 2, 2009. The amount of shares reserved for the Purchase Plan increased by 230 thousand shares on the first stock market trading day of 2010. There is no provision for an automatic share reserve increase in either the 2009 Plan or the 2009 Purchase Plan.

*2009 Stock Incentive Plan*

In fiscal 2009, the Company's Board of Directors and stockholders approved the 2009 Plan, which has a term of 10 years from the shareholders' approval date. Under the 2009 Plan, the following may be granted: stock options, stock appreciation rights, performance shares, performance stock units, restricted stock units, performance-based awards and other awards (collectively, all such grants are referred to as "awards"). Awards of stock options and stock appreciation rights each deduct one share from the 2009 Plan shares available for issuance for each share granted, and full value awards (awards other than for which the participant is required to pay at least the fair market value of the underlying shares on the date of grant) deduct 1.55 shares from the 2009 Plan shares available for issuance for each share granted. Awards granted under the 2009 Plan generally contain vesting provisions ranging from three to four years. The exercise price of stock options granted under the 2009 Plan may not be less than 100% of the fair market value of a share of our common stock on the date of grant. To the extent awards granted under the 2009 Plan terminate, expire or lapse for any reason, or are settled in cash, shares subject to such awards will again be available for grant.

*2000 Stock Incentive Plan*

In fiscal 2000, the Company's Board of Directors and stockholders approved the 2000 Plan. The 2000 Plan contains programs for (i) the discretionary granting of stock options to employees, non-employee board members and consultants for the purchase of shares of the Company's common stock, (ii) the discretionary issuance of common stock directly (as granted under direct issuance shares in stock awards and restricted stock units (RSUs)), (iii) the granting of special below-market stock options to executive officers and other highly compensated employees of the Company for which the exercise price can be paid using payroll deductions and (iv) the automatic issuance of stock options to non-employee board members. The discretionary issuance of common stock, RSUs and stock options generally contain vesting provisions ranging from three to eight years. If permitted by the Company, stock options can be exercised immediately and, similar to the direct issuance shares, are subject to repurchase rights which generally lapse in accordance with the vesting schedule. The repurchase rights provide that upon certain defined events, the Company can repurchase unvested shares at the price paid per share. The term of each stock option is no more than ten years from the date of grant.

**Silicon Laboratories Inc.**
**Notes to Consolidated Financial Statements (Continued)**
**January 2, 2010**

**13. Stock-Based Compensation (Continued)**

*Stock Grants and Modifications*

The Company granted to its employees zero, 0.3 million and 0.5 million stock options, and 0.8 million, 1.0 million and 1.0 million of stock awards and RSUs from the 2000 Plan during fiscal 2009, 2008 and 2007, respectively. The Company granted to its employees 0.2 million of stock awards and RSUs from the 2009 Plan during fiscal 2009. The Company recorded $5.5 million of stock compensation expense in "Income from discontinued operations, net of income taxes" during fiscal 2007 in connection with modifications of equity grants to employees who were hired by NXP in connection with the sale of the Aero product lines. As of the closing date of the sale, the Company accelerated the vesting of 0.5 million shares of options and awards, and extended the exercise period of 0.9 million shares of options through December 31, 2007. Further, the Company cancelled 0.3 million shares of unvested options and awards related to the terminated employees. There were no other significant modifications made to any stock grants during these periods.

*2009 Employee Stock Purchase Plan*

In fiscal 2009, the Company's Board of Directors and stockholders approved the 2009 Purchase Plan. The rights to purchase common stock granted under the 2009 Purchase Plan are intended to be treated as either (i) purchase rights granted under an "employee stock purchase plan," as that term is defined in Section 423(b) of the Internal Revenue Code (*i.e.,* the 423(b) Plan), or (ii) purchase rights granted under an employee stock purchase plan that is not subject to the terms and conditions of Section 423(b) of the Internal Revenue Code (*i.e.*, the Non-423(b) Plan). The Company will retain the discretion to grant purchase rights under either the 423(b) Plan or the Non-423(b) Plan. Eligible employees may purchase a limited number of shares of the Company's common stock at no less than 85% of the fair market value of a share of common stock at prescribed purchase intervals during an offering period. Each offering period will be comprised of a series of one or more successive and/or overlapping purchase intervals and has a maximum term of 24 months.

*Employee Stock Purchase Plan*

The Purchase Plan was adopted by the Company's Board of Directors in fiscal 2000. Eligible employees may purchase a limited number of shares of the Company's common stock at 85% of the market value during a series of offering periods. Each offering period is divided into semi-annual purchase intervals and has a maximum term of 24 months. During fiscal 2009, 2008 and 2007, the Company issued a total of 148,000, 120,000 and 116,000 shares under the Purchase Plan to its employees. The weighted-average fair value for purchase rights granted under the Purchase Plan for fiscal 2009 was $10.49 per share.

*Accounting for Stock Compensation*

Stock-based compensation costs are generally based on the fair values on the date of grant for stock options and on the date of enrollment for the employee stock purchase plans, estimated by using the Black-Scholes option-pricing model. The fair values of stock awards and RSUs generally equal their intrinsic value on the date of grant.

**Silicon Laboratories Inc.**
**Notes to Consolidated Financial Statements (Continued)**
**January 2, 2010**

**13. Stock-Based Compensation (Continued)**

The Black-Scholes valuation calculation requires us to estimate key assumptions such as future stock price volatility, expected terms, risk-free rates and dividend yield. Expected stock price volatility is based upon a combination of both historical volatility and implied volatility derived from traded options on the Company's stock in the marketplace. Expected term is derived from an analysis of historical exercises and remaining contractual life of options. The risk-free rate is based on the U.S. Treasury yield curve in effect at the time of grant. The Company has never paid cash dividends and does not currently intend to pay cash dividends, thus it has assumed a 0% dividend yield.

The Company must estimate potential forfeitures of stock grants and adjust compensation cost recorded accordingly. The estimate of forfeitures will be adjusted over the requisite service period to the extent that actual forfeitures differ, or are expected to differ, from such estimates. Changes in estimated forfeitures are recognized through a cumulative catch-up adjustment in the period of change and will also impact the amount of stock compensation expense to be recognized in future periods.

The fair values of stock options and RSUs are amortized as compensation expense on a straight-line basis over the vesting period of the grants. The fair values of stock awards are fully expensed in the period of grant, when shares are immediately issued with no vesting restrictions. Compensation expense from continuing operations recognized is shown in the operating activities section of the Consolidated Statements of Cash Flows.

The fair values estimated from the Black-Scholes option-pricing model were calculated using the following assumptions:

| | | Year Ended | |
|---|---|---|---|
| | **January 2, 2010** | **January 3, 2009** | **December 29, 2007** |
| *2000 Stock Incentive Plan:* | | | |
| Expected volatility | | 44% | 48% |
| Risk-free interest rate % | | 2.6% | 4.6% |
| Expected term (in years) | | 5.0 | 4.9 |
| Dividend yield | | | |
| *Employee Stock Purchase Plan:* | | | |
| Expected volatility | 44% | 41% | 37% |
| Risk-free interest rate % | 0.3% | 1.3% | 4.8% |
| Expected term (in months) | 8 | 12 | 14 |
| Dividend yield | | | |

There were no stock options granted during fiscal 2009.

**Silicon Laboratories Inc.**
**Notes to Consolidated Financial Statements (Continued)**
**January 2, 2010**

**13. Stock-Based Compensation (Continued)**

A summary of the Company's stock compensation activity with respect to fiscal 2009 follows:

| Stock Options | Shares (000s) | Weighted-Average Exercise Price | Weighted-Average Remaining Contractual Term (In Years) | Aggregate Intrinsic Value ($000s) |
|---|---|---|---|---|
| Outstanding at January 3, 2009 | 5,254 | $ 32.84 | | |
| Granted | | | | |
| Exercised | (1,048) | 27.50 | | |
| Cancelled or expired | (160) | 41.86 | | |
| Outstanding at January 2, 2010 | 4,046 | $ 33.86 | 4.6 | $ 60,976 |
| Vested at January 2, 2010 and expected to vest | 4,030 | $ 33.86 | 4.6 | $ 60,742 |
| Exercisable at January 2, 2010 | 3,502 | $ 33.94 | 4.2 | $ 52,811 |

| Stock Awards and RSUs | Shares (000s) | Weighted-Average Purchase Price | Weighted-Average Remaining Vesting Term (In Years) | Aggregate Intrinsic Value ($000s) |
|---|---|---|---|---|
| Outstanding at January 3, 2009 | 2,023 | $ 0.00 | | |
| Granted | 951 | 0.00 | | |
| Issued | (662) | 0.00 | | |
| Cancelled or expired | (80) | 0.00 | | |
| Outstanding at January 2, 2010 | 2,232 | $ 0.00 | 1.3 | $ 107,999 |
| Outstanding at January 2, 2010 and expected to vest | 2,059 | $ 0.00 | 1.3 | $ 99,593 |
| Exercisable at January 2, 2010 | | $ | | $ |

The following summarizes the Company's weighted average fair value at the date of grant (including activity related to discontinued operations):

| | Year Ended January 2, 2010 | January 3, 2009 | December 29, 2007 |
|---|---|---|---|
| Per grant of stock options | $ | $ 12.92 | $ 16.18 |
| Per grant of stock award or RSUs | $ 27.45 | $ 31.77 | $ 34.28 |

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**Silicon Laboratories Inc.**
**Notes to Consolidated Financial Statements (Continued)**
**January 2, 2010**

**13. Stock-Based Compensation (Continued)**

The following summarizes the Company's stock-based payment and stock option values (in thousands):

| | Year Ended | | |
|---|---|---|---|
| | January 2, 2010 | January 3, 2009 | December 29, 2007 |
| Intrinsic value of stock options exercised | $ 14,549 | $ 5,454 | $ 23,684 |
| Intrinsic value of stock awards issued and RSUs that vested | $ 23,983 | $ 19,469 | $ 22,661 |
| Grant date fair value of stock awards and RSUs that vested | $ 22,764 | $ 22,420 | $ 22,416 |

The Company had approximately $51.3 million of total unrecognized compensation costs related to stock options, stock and RSUs at January 2, 2010 that are expected to be recognized over a weighted-average period of 1.7 years. There were no significant stock compensation costs capitalized into assets in any of the periods presented.

The Company received cash of $25.2 million for the issuance of common stock, net of shares withheld for taxes during fiscal 2009. The Company issues shares from the shares reserved under its stock plans upon the exercise of stock options, issuance of stock awards, and vesting of RSUs. The Company does not currently expect to repurchase shares from any source to satisfy such obligation under the Plan.

The following are the stock-based compensation costs recognized in the Company's Consolidated Statements of Income (in thousands):

| | Year Ended | | |
|---|---|---|---|
| | January 2, 2010 | January 3, 2009 | December 29, 2007 |
| Cost of revenues | $ 1,457 | $ 1,437 | $ 1,539 |
| Research and development | 13,866 | 14,906 | 16,385 |
| Selling, general and administrative | 28,651 | 24,326 | 22,054 |
| | 43,974 | 40,669 | 39,978 |
| Provision for income taxes | 6,221 | 5,647 | 6,755 |
| | $ 37,753 | $ 35,022 | $ 33,223 |

**Silicon Laboratories Inc.**
**Notes to Consolidated Financial Statements (Continued)**
**January 2, 2010**

### 13. Stock-Based Compensation (Continued)

As of January 2, 2010, the Company had reserved shares of common stock for future issuance as follows (in thousands):

| | |
|---|---|
| 2000 Stock Incentive Plan | 6,132 |
| 2009 Stock Incentive Plan | 6,731 |
| Employee Stock Purchase Plan(1) | 1,795 |
| 2009 Employee Stock Purchase Plan | 1,250 |
| Total shares reserved | 15,908 |

(1) Shares reserved for the Employee Stock Purchase Plan will be cancelled upon the effective date of the 2009 Employee Stock Purchase Plan on April 30, 2010.

### 14. Employee Benefit Plan

The Company maintains a defined contribution or 401(k) Plan for its qualified U.S. employees. Participants may contribute a percentage of their compensation on a pre-tax basis, subject to a maximum annual contribution imposed by the Internal Revenue Code. The Company may make discretionary matching contributions as well as discretionary profit-sharing contributions to the 401(k) Plan. The Company contributed $2.2 million, $2.2 million and $1.8 million to the 401(k) Plan during fiscal 2009, 2008 and 2007, respectively.

### 15. Commitments and Contingencies

*Operating Leases*

The Company leases its facilities under operating lease agreements that expire at various dates through 2019. Some of these arrangements contain renewal options and require the Company to pay taxes, insurance and maintenance costs.

Rent expense under operating leases was $5.1 million, $3.8 million and $4.6 million for fiscal 2009, 2008 and 2007, respectively.

The minimum annual future rentals under the terms of these leases as of January 2, 2010 are as follows (in thousands):

| **Fiscal Year** | |
|---|---|
| 2010 | $ 7,642 |
| 2011 | 6,636 |
| 2012 | 6,474 |
| 2013 | 2,550 |
| 2014 | 1,307 |
| Thereafter | 5,671 |
| Total minimum lease payments | 30,280 |
| Minimum sublease rental income | (8,466) |
| Total net minimum lease payments | $ 21,814 |

**Silicon Laboratories Inc.**
**Notes to Consolidated Financial Statements (Continued)**
**January 2, 2010**

**15. Commitments and Contingencies (Continued)**

*Headquarters Leases*

In March 2006, the Company entered into an operating lease agreement and a related participation agreement for a facility at 400 W. Cesar Chavez ("400 WCC") in Austin, Texas for its corporate headquarters. The lease has a term of seven years. The base rent for the term of the lease is an amount equal to the interest accruing on $44.3 million at 110 basis points over the three-month LIBOR (which would be approximately $1.9 million over the remaining term assuming LIBOR averages 0.25% during such term).

In March 2008, the Company entered into an operating lease agreement and a related participation agreement for a facility at 200 W. Cesar Chavez ("200 WCC") in Austin, Texas for the expansion of its corporate headquarters. The lease has a term of five years. The base rent for the term of the lease is an amount equal to the interest accruing on $50.1 million at 155 basis points over the three-month LIBOR (which would be approximately $2.9 million over the remaining term assuming LIBOR averages 0.25% during such term).

The Company has granted certain rights and remedies to the lessors in the event of certain defaults, including the right to terminate the leases, to bring suit to collect damages, and to compel the Company to purchase the facilities. The leases contain other customary representations, warranties, obligations, conditions, indemnification provisions and termination provisions, including covenants that the Company shall maintain unencumbered cash and highly-rated short-term investments of at least $75 million. If the Company's unencumbered cash and highly-rated short-term investments are less than $150 million, it must also maintain a ratio of funded debt to earnings before interest expense, income taxes, depreciation, amortization, lease expense and other non-cash charges (EBITDAR) over the four prior fiscal quarters of no greater than 2 to 1. As of January 2, 2010, the Company believes it was in compliance with all covenants of the leases.

During the terms of the leases, the Company has on-going options to purchase the buildings for purchase prices of approximately $44.3 million for 400 WCC and $50.1 million for 200 WCC. Alternatively, the Company can cause each such property to be sold to third parties provided it is not in default under that property's lease. The Company is contingently liable on a first dollar loss basis for up to $35.3 million to the extent that the 400 WCC sale proceeds are less than the $44.3 million purchase option and up to $40.0 million to the extent that the 200 WCC sale proceeds are less than the $50.1 million purchase option.

The Company determined that the fair value associated with the guaranteed residual values was $1.0 million for 400 WCC and $1.2 million for 200 WCC, as of the inception of the leases. These amounts were recorded in "Other assets, net" and "Long-term obligations and other liabilities" in the Consolidated Balance Sheets and are being amortized over the term of the leases.

The Company is required to periodically evaluate the expected fair value of each facility at the end of the lease terms. If the Company determines that it is estimable and probable that the expected fair values will be less than $44.3 million for 400 WCC and $50.1 million for 200 WCC, it will ratably accrue the loss up to a maximum of approximately $35.3 million and $40.0 million, respectively, over the remaining lease terms as additional rent expense. As of January 2, 2010, the Company does not believe that a loss contingency accrual is required for either property. However, a prolonged economic downturn could increase the likelihood of such a loss accrual.

**Silicon Laboratories Inc.**
**Notes to Consolidated Financial Statements (Continued)**
**January 2, 2010**

**15. Commitments and Contingencies (Continued)**

*Interest Rate Swap Agreements*

In connection with its headquarters leases, during fiscal 2008 the Company entered into interest rate swap agreements as a hedge against the variable rent under the leases. Under the terms of the swap agreements, the Company has effectively converted the variable rents to fixed rents through March 2011 for 400 WCC and March 2013 for 200 WCC. See Note 6, *Derivative Financial Instruments*, for additional information.

*Litigation*

*Securities Litigation*

On December 6, 2001, a class action complaint for violations of U.S. federal securities laws was filed in the United States District Court for the Southern District of New York against the Company, four officers individually and the three investment banking firms who served as representatives of the underwriters in connection with the Company's initial public offering of common stock. The Consolidated Amended Complaint alleges that the registration statement and prospectus for the Company's initial public offering did not disclose that (1) the underwriters solicited and received additional, excessive and undisclosed commissions from certain investors, and (2) the underwriters had agreed to allocate shares of the offering in exchange for a commitment from the customers to purchase additional shares in the aftermarket at pre-determined higher prices. The Complaint alleges violations of the Securities Act of 1933 and the Securities Exchange Act of 1934. The action seeks damages in an unspecified amount and is being coordinated with approximately 300 other nearly identical actions filed against other companies. A court order dated October 9, 2002 dismissed without prejudice the four officers of the Company who had been named individually. On December 5, 2006, the Second Circuit vacated a decision by the District Court granting class certification in six of the coordinated cases, which are intended to serve as test, or "focus" cases. The plaintiffs selected these six cases, which do not include the Company. On April 6, 2007, the Second Circuit denied a petition for rehearing filed by the plaintiffs, but noted that the plaintiffs could ask the District Court to certify more narrow classes than those that were rejected.

The parties in the approximately 300 coordinated cases, including the parties in the case against the Company, reached a settlement. The insurers for the issuer defendants in the coordinated cases will make the settlement payment on behalf of the issuers, including the Company. On October 5, 2009, the Court granted final approval of the settlement. Six notices of appeal have been filed. Judgment was entered on January 13, 2010. The time to file additional notices of appeal is set to expire on February 12, 2010. A group of three objectors, who filed a notice of appeal, also filed a petition to the Second Circuit seeking permission to appeal the District Court's final approval of the settlement on the basis that the settlement class is broader than the class previously rejected by the Second Circuit in its December 5, 2006 order vacating the District Court's order certifying classes in the focus cases.

As the litigation process is inherently uncertain, the Company is unable to predict the outcome of the above described matter if the settlement does not survive the appeal. While the Company does maintain liability insurance, it could incur losses that are not covered by its liability insurance or that exceed the limits of its liability insurance. Such losses could have a material impact on the Company's business and its results of operations or financial position.

**Silicon Laboratories Inc.**
**Notes to Consolidated Financial Statements (Continued)**
**January 2, 2010**

### 15. Commitments and Contingencies (Continued)

*Other*

The Company is involved in various other legal proceedings that have arisen in the normal course of business. While the ultimate results of these matters cannot be predicted with certainty, the Company does not expect them to have a material adverse effect on its consolidated financial position or results of operations.

*Discontinued Operations Indemnification*

In connection with the sale of the Aero product lines, the Company agreed to indemnify NXP with respect to liabilities for certain tax matters. There is no contractual limit on exposure with respect to such matters. As of January 2, 2010, the Company had no material liabilities recorded with respect to this indemnification obligation.

### 16. Income Taxes

Significant components of the provision (benefit) for income taxes attributable to continuing operations are as follows (in thousands):

| | Year Ended January 2, 2010 | January 3, 2009 | December 29, 2007 |
|---|---|---|---|
| Current: | | | |
| Domestic | $ (11,560) | $ 14,557 | $ 5,182 |
| International | 5,538 | 3,808 | 1,809 |
| Total Current | (6,022) | 18,365 | 6,991 |
| Deferred: | | | |
| Domestic | 2,234 | 2,261 | (177) |
| International | (338) | (445) | 24 |
| Total Deferred | 1,896 | 1,816 | (153) |
| | $ (4,126) | $ 20,181 | $ 6,838 |

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**Silicon Laboratories Inc.**
**Notes to Consolidated Financial Statements (Continued)**
**January 2, 2010**

**16. Income Taxes (Continued)**

The Company's provision (benefit) for income taxes differs from the expected tax expense amount computed by applying the statutory federal income tax rate to income before income taxes as a result of the following:

| | Year Ended | | |
|---|---|---|---|
| | January 2, 2010 | January 3, 2009 | December 29, 2007 |
| Federal statutory rate | 35.0% | 35.0% | 35.0% |
| Stock compensation | 0.3 | 3.0 | 4.9 |
| Foreign tax rate benefit | (16.7) | (14.4) | (2.4) |
| Tax-exempt interest income | (0.6) | (3.0) | (11.6) |
| Research and development tax credits | (3.1) | (2.1) | (3.4) |
| In-process research and development | | 6.8 | |
| Release of prior year unrecognized tax benefits | (23.4) | (12.5) | (8.7) |
| Intercompany technology license | | 22.1 | |
| Other | 2.5 | 3.1 | 0.9 |
| | (6.0)% | 38.0% | 14.7% |

The effective tax rate for fiscal 2009 decreased from fiscal 2008, primarily due to the resolution of uncertain tax positions as a result of the Company entering into a unilateral Advance Pricing Agreement with the U.S. Internal Revenue Service during the fourth quarter of fiscal 2009. In addition, the effective tax rate for fiscal 2009 decreased from fiscal 2008 due to the intercompany license of certain technology and the non-deductible write-off of in-process research and development costs during fiscal 2008, both of which were related to the acquisition of Integration Associates. The increase in the effective rate for fiscal 2008 from fiscal 2007 was primarily attributable to a tax charge related to the intercompany license of certain technology obtained in the acquisition of Integration Associates, the non-deductible write-off of in-process research and development costs and lower tax-exempt interest income in fiscal 2008.

Income before income taxes included approximately $39.5 million, $22.6 million and $28.7 million related to foreign operations in fiscal 2009, 2008 and 2007, respectively.

At the end of fiscal 2009, undistributed earnings of the Company's foreign subsidiaries of approximately $237.9 million are considered permanently reinvested. Accordingly, no provision for U.S. federal and state income taxes has been made. Determination of the amount of the unrecognized deferred tax liability on these unremitted earnings is not practicable.

**Silicon Laboratories Inc.**
**Notes to Consolidated Financial Statements (Continued)**
**January 2, 2010**

**16. Income Taxes (Continued)**

Significant components of the Company's deferred taxes as of January 2, 2010 and January 3, 2009 are as follows (in thousands):

| | January 2, 2010 | January 3, 2009 |
|---|---|---|
| Deferred tax assets: | | |
| Net operating loss carryforwards | $ 2,246 | $ 5,945 |
| Research and development tax credit carryforwards | 3,926 | 4,211 |
| Stock compensation | 9,853 | 8,594 |
| Depreciable assets | 33,407 | 35,899 |
| Reserves and allowances | 335 | 560 |
| Unrealized losses on available-for-sale securities | 774 | 1,297 |
| Unrealized losses on cash flow hedges | 1,572 | 1,961 |
| Deferred income on shipments to distributors | 1,778 | 2,043 |
| Accrued liabilities and other | 4,629 | 3,880 |
| | 58,520 | 64,390 |
| Less: Valuation allowance | | |
| | 58,520 | 64,390 |
| Deferred tax liabilities: | | |
| Acquired intangibles | 13,882 | 16,174 |
| Long term obligations for tax purposes | 33,023 | 33,023 |
| Prepaid expenses and other | 857 | 751 |
| | 47,762 | 49,948 |
| Net deferred tax assets | $ 10,758 | $ 14,442 |

As of January 2, 2010, the Company had federal net operating loss and research and development credit carryforwards of approximately $3.6 million and $0.9 million, respectively, as a result of the Cygnal Integrated Products and Integration Associates acquisitions. These carryforwards expire in fiscal years 2019 through 2028. Recognition of these loss and credit carryforwards is subject to an annual limit, which may cause them to expire before they are used.

The Company also had state loss and research and development credit carryforwards of approximately $25.9 million and $5.0 million, respectively. A portion of these loss and credit carryforwards was generated by the Company and a portion was acquired through the Integration Associates acquisition. Certain of these carryforwards expire in fiscal years 2024 through 2028 and others do not expire. Recognition of some of these loss and credit carryforwards is subject to an annual limit, which may cause them to expire before they are used.

Deferred income taxes reflect the net tax effects of temporary differences between the carrying value of assets and liabilities for financial reporting purposes and the values used for income tax purposes. Related to the acquisition of Integration Associates in July 2008, the Company has recorded net deferred tax liabilities of approximately $5.1 million due to differences between book and tax bases of acquired assets and assumed liabilities.

**Silicon Laboratories Inc.**
**Notes to Consolidated Financial Statements (Continued)**
**January 2, 2010**

**16. Income Taxes (Continued)**

The Company's operations in Singapore are subject to reduced tax rates through 2019, as long as certain conditions are met. The income tax benefit reflected in earnings was approximately $6.3 million (representing $0.13 per diluted share) in fiscal 2009 and $5.9 million (representing $0.12 per diluted share) in fiscal 2008.

The Company adopted FASB ASC 740, formerly FASB Interpretation No. (FIN) 48, *Accounting for Uncertainty in Income Taxes,* at the beginning of fiscal 2007. A reconciliation of the beginning and ending amounts of unrecognized tax benefits is as follows (in thousands):

| | | |
|---|---|---|
| Balance at January 3, 2009 | $ | 32,695 |
| Additions based on tax positions related to prior years | | 4,127 |
| Reductions for tax positions related to prior years | | (14,954) |
| Reductions for tax positions as a result of a lapse of the applicable statute of limitations | | (1,197) |
| Reductions for settlements with taxing authorities | | (8,511) |
| Balance at January 2, 2010 | $ | 12,160 |

At January 2, 2010, the Company had gross unrecognized tax benefits of $12.2 million, $11.9 million of which would affect the effective tax rate if recognized. During fiscal 2009, the Company recorded gross decreases of $1.2 million to its unrecognized tax benefits related to the closure of an open tax year. During the fourth quarter of fiscal 2009, the Company entered into a unilateral Advance Pricing Agreement with the U.S. Internal Revenue Service which resolves certain intercompany transfer pricing matters beginning in fiscal 2005. As a result of the agreement, the Company recorded gross decreases of $15.0 million to its unrecognized tax benefits related to prior years and recorded gross decreases of $8.5 million related to settlements with taxing authorities, which it recorded as additional taxes payable of the same amount. In addition, the Company recorded gross increases of $4.1 million to its unrecognized tax benefits related to prior years, primarily due to uncertainty related to the deductibility of certain items.

The Company recognizes interest and penalties related to unrecognized tax benefits in the provision for income taxes. During fiscal 2009, 2008 and 2007, the Company recognized $0.8 million, $0.9 million and $1.0 million of interest, respectively, net of tax, in the provision for income taxes. In addition, the Company had decreases of interest, net of tax, of $1.8 million related to resolution of certain intercompany transfer pricing matters and the closure of an open tax year in fiscal 2009, of $1.2 million related to the closure of an open tax year in fiscal 2008 and of $1.1 million related to the closure of an income tax audit and the closure of open tax years in fiscal 2007. The Company had accrued $0.1 million and $1.7 million for the payment of interest related to unrecognized tax positions at the end of fiscal 2009 and 2008, respectively.

The tax years 2004 through 2009 remain open to examination by the major taxing jurisdictions to which the Company is subject. The Company's 2005 through 2008 federal income tax returns are under examination by the U.S. Internal Revenue Service. Although the outcome of tax audits is always uncertain, the Company believes that the results of the examination will not materially affect its financial position or results of operations.

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### 17. Segment Information

The Company has one operating segment, mixed-signal analog intensive ICs, consisting of numerous product areas. The Company's chief operating decision maker is considered to be its Chief Executive Officer. The chief operating decision maker allocates resources and assesses performance of the business and other activities at the operating segment level.

Revenue is attributed to a geographic area based on the end customer's shipped-to location. The following summarizes the Company's revenue by geographic area (in thousands):

| | Year Ended | | |
|---|---|---|---|
| | January 2, 2010 | January 3, 2009 | December 29, 2007 |
| United States | $ 54,065 | $ 51,829 | $ 43,743 |
| China | 105,509 | 94,779 | 79,261 |
| South Korea | 91,974 | 56,364 | 36,571 |
| Taiwan | 68,320 | 79,351 | 83,176 |
| Rest of world | 121,152 | 133,307 | 94,710 |
| Total | $ 441,020 | $ 415,630 | $ 337,461 |

The following summarizes the Company's property and equipment, net by geographic area (in thousands):

| | January 2, 2010 | January 3, 2009 |
|---|---|---|
| United States | $ 22,528 | $ 24,895 |
| Singapore | 3,739 | 3,453 |
| Rest of world | 1,518 | 2,148 |
| Total | $ 27,785 | $ 30,496 |

### 18. Headquarter Relocation Costs

In fiscal 2006, the Company relocated most of its Austin, Texas employees to a new corporate headquarters. In fiscal 2007, the Company relocated the remainder of its Austin employees to its headquarters. The Company recorded $3.8 million for the expected costs related to vacating certain leased facilities in the "selling, general and administrative" line of the Consolidated Statements of Income. The following table summarizes the accrued relocation costs activity (in thousands):

| Fiscal Year | Balance at Beginning of Year | Additions Charged to Expenses | Deductions(1) | Balance at End of Year |
|---|---|---|---|---|
| 2009 | $ 986 | $ | $ 916 | $ 70 |
| 2008 | 2,618 | | 1,632 | 986 |
| 2007 | 2,261 | 704 | 347 | 2,618 |

(1) Deductions represent lease and brokerage commission payments.

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### 19. Subsequent Events

The Company evaluates events and transactions that occur after the balance sheet date as potential subsequent events. This evaluation was performed through February 10, 2010, the date on which the Company's financial statements were issued.

**Supplementary Financial Information (Unaudited)**

Quarterly financial information for fiscal 2009 and 2008 is as follows. The first quarter of fiscal 2008 had 14 weeks. All other quarterly periods reported here had 13 weeks (in thousands, except per share amounts):

| | Fiscal 2009 | | | |
|---|---|---|---|---|
| | Fourth Quarter | Third Quarter | Second Quarter | First Quarter |
| Revenues | $ 127,190 | $ 125,913 | $ 104,216 | $ 83,701 |
| Gross margin | 83,260 | 81,035 | 64,781 | 50,678 |
| Operating income | 26,078 | 26,539 | 12,726 | 1,167 |
| Net income | $ 40,251(2) | $ 22,439 | $ 9,730 | $ 671 |
| Earnings per share: | | | | |
| Basic | $ 0.88 | $ 0.50 | $ 0.22 | $ 0.02 |
| Diluted | $ 0.84 | $ 0.47 | $ 0.21 | $ 0.01 |

| | Fiscal 2008 | | | |
|---|---|---|---|---|
| | Fourth Quarter | Third Quarter | Second Quarter | First Quarter |
| Revenues | $ 99,348 | $ 113,483 | $ 104,620 | $ 98,179 |
| Gross margin | 60,096 | 69,309 | 66,033 | 60,347 |
| Operating income | 7,088 | 7,334(1) | 18,169 | 11,065 |
| Net income | $ 6,324 | $ 1,154(1) | $ 14,643 | $ 10,814 |
| Earnings per share: | | | | |
| Basic | $ 0.14 | $ 0.02 | $ 0.30 | $ 0.21 |
| Diluted | $ 0.14 | $ 0.02 | $ 0.29 | $ 0.21 |

(1) Includes a charge for in-process research and development costs in connection with our acquisition of Integration Associates.

(2) Includes a benefit related to the resolution of prior year uncertain tax benefits.