

CONEXANT SYSTEMS INC

Form 10-Q

August 09, 2005

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

FORM 10-Q

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

**For the quarterly period ended June 30, 2005\***

**OR**

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

**Commission file number: 000-24923**

**CONEXANT SYSTEMS, INC.**

(Exact name of registrant as specified in its charter)

**Delaware**

(State of incorporation)

**25-1799439**

(I.R.S. Employer Identification No.)

**4000 MacArthur Boulevard**

**Newport Beach, California 92660-3095**

(Address of principal executive offices) (Zip code)

**(949) 483-4600**

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

Indicate by check mark whether the registrant is an accelerated filer (as defined by Rule 12b-2 of the Exchange Act).

Yes  No

Number of shares of registrant's common stock outstanding as of July 29, 2005 was 473,411,213.

\* For presentation purposes of this Form 10-Q, references made to the June 30, 2005 period relate to the actual second fiscal quarter ended July 1, 2005.

**Table of Contents****CAUTIONARY STATEMENT**

Safe Harbor Statement under the Private Securities Litigation Reform Act of 1995: This Quarterly Report on Form 10-Q includes forward-looking statements intended to qualify for the safe harbor from liability established by the Private Securities Litigation Reform Act of 1995. These forward-looking statements generally can be identified by phrases such as Conexant or the company believes, expects, anticipates, foresees, forecasts, estimates or other or phrases of similar import. Similarly, statements in this Quarterly Report on Form 10-Q that describe the company's business strategy, outlook, objectives, plans, intentions or goals also are forward-looking statements. All such forward-looking statements are subject to certain risks and uncertainties that could cause actual results to differ materially from those in forward-looking statements.

Conexant's future results will be affected by the implementation of new accounting rules related to the expensing of stock options commencing in fiscal 2006. Other risks and uncertainties include, but are not limited to: general economic and political conditions and conditions in the markets the company addresses; the substantial losses the company has incurred recently; the cyclical nature of the semiconductor industry and the markets addressed by the company's and its customers' products; continuing volatility in the technology sector and the semiconductor industry; demand for and market acceptance of new and existing products; successful development of new products; the timing of new product introductions and product quality; the company's ability to anticipate trends and develop products for which there will be market demand; the availability of manufacturing capacity; pricing pressures and other competitive factors; changes in product mix; product obsolescence; the ability of the company's customers to manage inventory; the ability to develop and implement new technologies and to obtain protection for the related intellectual property; the uncertainties of litigation and the demands it may place on the time and attention of company management; and possible disruptions in commerce related to terrorist activity or armed conflict, as well as other risks and uncertainties, including those detailed from time to time in our Securities and Exchange Commission filings. These forward-looking statements are made only as of the date hereof. We undertake no obligation to update or revise the forward-looking statements, whether as a result of new information, future events or otherwise.

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ITEM 1. FINANCIAL STATEMENTS****CONEXANT SYSTEMS, INC.  
Consolidated Condensed Balance Sheets  
(unaudited, in thousands, except per share amounts)**

	<b>June 30, 2005</b>	<b>September 30, 2004</b>
<b>ASSETS</b>		
<b>Current assets:</b>		
Cash and cash equivalents	\$ 160,496	\$ 139,031
Short-term investments	153,286	163,040
Receivables, net of allowance of \$3,955 and \$5,974 at June 30, 2005 and September 30, 2004, respectively	82,345	185,037
Inventories	103,491	194,754
Mindspeed warrant-current portion		3,599
Other current assets	19,745	20,768
Total current assets	519,363	706,229
Property, plant and equipment, net	50,333	55,741
Goodwill	718,335	708,544
Intangible assets, net	114,628	135,241
Mindspeed warrant	11,242	23,000
Marketable securities	72,024	137,604
Other assets	105,871	114,163
Total assets	\$ 1,591,796	\$ 1,880,522

**LIABILITIES AND SHAREHOLDERS EQUITY****Current liabilities:**

Accounts payable	\$ 94,655	\$ 141,533
Accrued compensation and benefits	38,149	40,423
Restructuring and reorganization liabilities	25,278	22,427
Other current liabilities	58,329	67,044
Current portion of convertible subordinated notes	196,825	
Total current liabilities	413,236	271,427
Convertible subordinated notes, net of current portion	515,000	711,825
Other liabilities	97,653	68,883
Total liabilities	1,025,889	1,052,135

Commitments and contingencies

**Shareholders equity:**

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Preferred and junior preferred stock		
Common stock, \$0.01 par value: 1,000,000 shares authorized; 472,471 and 469,441 shares issued, and 471,288 shares and 468,257 shares outstanding at June 30, 2005 and September 30, 2004, respectively	4,725	4,694
Treasury stock: 1,184 shares at cost	(5,584)	(5,584)
Additional paid-in capital	4,654,913	4,648,325
Accumulated deficit	(4,103,247)	(3,877,176)
Accumulated other comprehensive income	30,945	82,551
Notes receivable from stock sales	(336)	(576)
Unearned compensation	(15,509)	(23,847)
Total shareholders' equity	565,907	828,387
Total liabilities and shareholders' equity	\$ 1,591,796	\$ 1,880,522

See accompanying notes to consolidated condensed financial statements.

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**CONEXANT SYSTEMS, INC.**  
**Consolidated Condensed Statements of Operations**  
**(unaudited, in thousands, except per share amounts)**

	Three months ended		Nine months ended	
	June 30,		June 30,	
	2005	2004	2005	2004
Net revenues	\$ 197,464	\$ 267,617	\$ 507,823	\$ 688,731
Cost of goods sold	122,430	155,136	365,661	395,448
Gross margin	75,034	112,481	142,162	293,283
Operating expenses:				
Research and development <sup>(1)</sup>	66,282	74,317	209,362	167,205
Selling, general and administrative <sup>(1)</sup>	31,081	36,371	89,449	89,782
Amortization of intangible assets	7,969	7,956	24,402	12,564
In-process research and development				160,818
Special charges	8,409	8,294	41,262	14,413
Total operating expenses	113,741	126,938	364,475	444,782
Operating loss	(38,707)	(14,457)	(222,313)	(151,499)
Interest expense	8,396	8,373	25,290	22,322
Other (income) expense, net	(15,610)	47,935	(23,367)	(1,031)
Loss before income taxes	(31,493)	(70,765)	(224,236)	(172,790)
Provision for income taxes	673	661	1,835	1,368
Net loss	\$ (32,166)	\$ (71,426)	\$ (226,071)	\$ (174,158)
Net loss per share   basic and diluted	\$ (0.07)	\$ (0.15)	\$ (0.48)	\$ (0.48)
Number of shares used in per share computation	471,247	463,804	469,935	363,654

<sup>(1)</sup> Non-cash employee stock compensation is included in the above captions as follows:

	<b>Three months ended</b>		<b>Nine months ended</b>	
	<b>June 30,</b>		<b>June 30,</b>	
	<b>2005</b>	<b>2004</b>	<b>2005</b>	<b>2004</b>
Research and development	\$2,275	\$2,237	\$6,795	\$3,131
Selling, general and administrative	744	743	2,232	1,029

See accompanying notes to consolidated condensed financial statements.

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**CONEXANT SYSTEMS, INC.**  
**Consolidated Condensed Statements of Cash Flows**  
**(unaudited, in thousands)**

	<b>Nine months ended June 30,</b>	
	<b>2005</b>	<b>2004</b>
<b>Cash flows from operating activities:</b>		
Net loss	\$(226,071)	\$(174,158)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities, net of effects of acquisitions:		
Depreciation	14,054	11,337
Amortization of intangible assets	24,402	12,564
In-process research and development		160,818
Reduction of provision for bad debt	(1,543)	
Inventory provisions	50,150	6,046
Decrease in fair value of Skyworks note and Mindspeed warrant	14,804	44,671
Equity in losses (earnings) of equity method investees	8,587	(12,750)
Gain on sale of equity securities, investments and other assets	(42,310)	(27,017)
Stock compensation, option modification charges and other	9,027	6,268
Other non-cash items, net	(299)	6,200
Changes in assets and liabilities:		
Receivables	104,386	(42,174)
Inventories	43,324	(18,631)
Accounts payable	(47,535)	30,131
Agere patent litigation settlement	(8,000)	
Special charges and other restructuring related items, net of \$45.5 million and \$10.9 million of payments, respectively	(4,241)	3,542
Accrued expenses and other current liabilities	7,947	5,400
Other	(5,348)	(10,589)
Net cash provided by (used in) operating activities	(58,666)	1,658
<b>Cash flows from investing activities:</b>		
Cash paid for acquisitions, net of cash acquired	(18,817)	24,752
Sales of equity securities, investments and other assets	44,360	31,580
Purchases of marketable securities	(45,244)	(67,816)
Sales and maturities of other marketable securities	68,831	38,384
Net proceeds from purchase and sale-leaseback and other	49,071	
Capital expenditures	(16,426)	(13,922)
Payment of merger costs		(29,764)
Payment of deferred purchase consideration		(4,000)
Investments in businesses	(2,580)	(2,619)
Net cash provided by (used in) investing activities	79,195	(23,405)
<b>Cash flows from financing activities:</b>		

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Proceeds from exercise of stock options	740	24,110
Repayment of notes receivable from stock sales	196	
Net cash provided by financing activities	936	24,110
Net increase in cash and cash equivalents	21,465	2,363
Cash and cash equivalents at beginning of period	139,031	76,186
Cash and cash equivalents at end of period	\$ 160,496	\$ 78,549

See accompanying notes to consolidated condensed financial statements.

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**CONEXANT SYSTEMS, INC.**  
**NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS**  
**(unaudited)**

**1. Basis of Presentation and Significant Accounting Policies**

Conexant Systems, Inc. (Conexant or the Company) designs, develops and sells semiconductor system solutions, comprised of semiconductor devices, software and reference designs, for use in broadband communications applications that enable high-speed transmission, processing and distribution of audio, video, voice and data to and throughout homes and business enterprises worldwide. The Company's access solutions connect people through personal communications access products such as personal computers (PCs), set-top boxes and game consoles to audio, video, voice and data services over wireless and wire line broadband connections as well as over dial-up Internet connections. The Company's central office solutions are used by service providers to deliver high-speed audio, video, voice and data services over copper telephone lines to homes and businesses around the globe. In addition, the Company's media processing products enable the capture, display, storage, playback and transfer of audio and video content in applications throughout home and small office environments. The Company operates in one reportable segment.

On February 27, 2004, the Company completed its merger with GlobespanVirata, Inc. (GlobespanVirata) with GlobespanVirata becoming a wholly-owned subsidiary of the Company. See Note 2 for further information.

**Interim Reporting** In the opinion of management, the accompanying unaudited consolidated condensed financial statements contain all adjustments, consisting of adjustments of a normal recurring nature, as well as the special charges, necessary to present fairly the Company's financial position, results of operations and cash flows. The results of operations for interim periods are not necessarily indicative of the results that may be expected for a full year. These statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended September 30, 2004.

**Fiscal Periods** For presentation purposes, references made to the periods ended June 30, 2004 and 2005, relate to the actual fiscal 2004 third quarter ended July 2, 2004 and the actual third fiscal quarter of 2005 ended July 1, 2005, respectively.

**Supplemental Cash Flow Information** Cash paid for interest was \$20.0 million and \$16.6 million for the nine months ended June 30, 2005 and 2004, respectively. Cash paid for income taxes for the nine months ended June 30, 2005 and 2004 was \$1.9 million and \$0.2 million, respectively.

**Revenue Recognition** The Company recognizes revenue when (1) the risk of loss has been transferred to the customer, (2) price and terms are fixed, (3) no significant vendor obligation exists, and (4) collection of the receivable is reasonably assured. These terms are typically met upon shipment of product to the customer, except for certain distributors who have a contractual right of return. Revenue with respect to these distributors is deferred until the purchased products are sold through by the distributor to a third party. Other distributors have limited stock rotation rights, which allow them to rotate up to 10% of product in their inventory two times a year. The Company recognizes revenue to these distributors upon shipment of product to the distributor, as the stock rotation rights are limited and the Company believes that it has the ability to estimate and establish allowances for expected product returns in accordance with Statement of Financial Accounting Standards (SFAS) No. 48, Revenue Recognition When Right of Return Exists. Development revenue is recognized when services are performed and was not significant for any of the periods presented.

Conexant has more than 20 distributor customers for whom revenue is recognized upon its shipment of product to them, as the contractual terms provide for no or limited rights of return. During the three months ended December 31, 2004, the Company determined that it was unable to enforce its contractual terms with three distribution customers. As a result, from October 1, 2004, the Company has deferred the recognition of revenue on sales to these three distributors until the purchased products are sold by the distributors to a third party.

**Income (Loss) Per Share** Basic income (loss) per share is based on the weighted-average number of shares of common stock outstanding during the period. Diluted loss per share also includes the effect of stock options and other common stock equivalents outstanding during the period, and assumes the conversion of the Company's convertible subordinated notes for the period of time such notes were outstanding, if such stock options and convertible notes are

dilutive. In periods of a net loss position, basic and diluted weighted average shares are the same.

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The potential dilutive effect of the common stock equivalents shown below was not included in the denominator for the computation of diluted earnings per share for the respective periods, as the effect of these securities was antidilutive:

(weighted-average number of shares, in thousands)	Three months ended		Nine months ended	
	June 30,		June 30,	
	2005	2004	2005	2004
Stock options and warrants (under the treasury stock method)	479	21,734	1,284	24,239
4.25% Convertible Subordinated Notes due 2006	7,364	7,364	7,364	7,364
5.25% Convertible Subordinated Notes due 2006	5,840	5,840	5,840	2,695
4.00% Convertible Subordinated Notes due 2007	12,137	12,137	12,137	12,137
Restricted stock	5	10	6	15

**Stock-Based Compensation** The Company accounts for employee stock-based compensation in accordance with the provisions of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB 25) and therefore no compensation expense has been recognized for fixed stock option plans as options are granted at fair market value on the date of grant. The Company also has an employee stock purchase plan for all eligible employees. The Company has adopted the pro forma disclosure provisions of SFAS No. 123, Accounting for Stock-Based Compensation, as amended by SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure. Had stock-based compensation been determined based on the fair value at the grant date for awards consistent with the provisions of SFAS No. 123, the Company's pro forma net loss and pro forma net loss per share would have been the amounts indicated below (in thousands, except per share amounts):

	Three months ended		Nine months ended	
	June 30,		June 30,	
	2005	2004	2005	2004
Net loss, as reported	\$(32,166)	\$(71,426)	\$(226,071)	\$(174,158)
Add: expense determined under fair value accounting included in net loss, as reported	3,019	2,980	9,027	4,160
Deduct: total expense determined under fair value accounting for all awards	(14,952)	(15,946)	(49,494)	(38,505)
Pro forma net loss	\$(44,099)	\$(84,392)	\$(266,538)	\$(208,503)
Net loss per share basic and diluted, as reported	\$ (0.07)	\$ (0.15)	\$ (0.48)	\$ (0.48)
Pro forma net loss per share basic and diluted	\$ (0.09)	\$ (0.18)	\$ (0.57)	\$ (0.48)

For purposes of pro forma disclosures under SFAS No. 123, the estimated fair value of the stock-based awards is assumed to be amortized to expense over the instruments' vesting period. The fair value has been estimated at the date of grant using the Black-Scholes option valuation model with the following assumptions:

	Three months ended		Nine months ended	
	March 31,		June 30,	
	2005	2004	2005	2004

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Risk-free interest rate	3.77%	3.93%	3.85%	3.33%
Expected volatility	86%	97%	86%	97%
Dividend yield				
Expected life (years)	5.0	4.5	4.9	4.1
Weighted-average fair value of options granted	\$1.02	\$3.63	\$1.03	\$5.04

The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions, including the expected stock price volatility. Because awards held by employees and

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directors have characteristics significantly different from those of traded options, and because changes in the subjective input assumptions can materially affect the fair value estimate, in the opinion of management, the existing models do not necessarily provide a reliable single measure of the fair value of these options.

The Company accounts for non-employee stock-based compensation in accordance with the terms of SFAS No. 123 (See Note 7 Other).

**Shipping and Handling** In accordance with EITF 00-10, Accounting for Shipping and Handling Fees and Costs, the Company includes shipping and handling fees billed to customers in net revenues. Amounts incurred by the Company for freight are included in cost of goods sold.

**Recent Accounting Pronouncements** In December 2004, the Financial Accounting Standards Board issued SFAS No. 123 (R), Share-Based Payment. This pronouncement amends SFAS No. 123, and supersedes APB Opinion No. 25. SFAS No. 123 (R) requires that public companies account for awards of equity instruments issued to employees under the fair value method of accounting and recognize such amounts in the statement of operations. The implementation of this statement was delayed by the Securities and Exchange Commission and will be effective beginning with the Company's first quarter of fiscal 2006. The Company expects the impact of this new pronouncement to be significant to its results of operations.

**Cash, Cash Equivalents and Investments Marketable Securities** The Company considers all highly liquid investments with insignificant interest rate risk and original maturities of three months or less from the date of purchase to be cash equivalents. The carrying amounts of cash and cash equivalents approximate their fair values. Short-term marketable securities consist of mutual funds, debt securities with original maturity dates between ninety days and one year, and equity securities. Long-term marketable securities consist of debt securities with original maturity dates greater than one year. The Company's investments are classified as available-for-sale, and are reported at fair value at the balance sheet date. The unrealized gains and losses are reported as a component of accumulated other comprehensive income (loss). Management determines the appropriate classification of debt securities at the time of purchase and reassesses the classification at each reporting date. Gains and losses on the sale of available-for-sale investments are determined using the specific-identification method.

Equity securities included in short-term marketable securities represent the Company's common stock holdings in publicly traded companies and are classified as short-term based on the Company's ability and intent to liquidate the securities as necessary to meet liquidity requirements. The reported fair value of these equity securities is based on the quoted market prices of the securities at each reporting date. Based on the overall state of the stock market, the availability of buyers for the shares when the Company wants to sell, and other restrictions, at any point in time the amounts ultimately realized upon liquidation of these securities may be significantly different than the carrying value. Total cash, cash equivalents and marketable securities at June 30, 2005 and at September 30, 2004 are as follows (in thousands):

	<b>June 30, 2005</b>	<b>September 30, 2004</b>
Cash and cash equivalents	\$ 160,496	\$ 139,031
Equity securities- Skyworks Solutions, Inc. (6.2 million shares at June 30, 2005 and September 30, 2004)	46,248	61,767
Equity securities- SiRF Technology Holdings, Inc. (2.8 million and 5.9 million shares at June 30, 2005 and September 30, 2004, respectively)	48,977	87,509
Other short-term marketable securities (primarily mutual funds, domestic government agency securities and corporate debt securities)	58,061	13,764
Subtotal- short-term investments	153,286	163,040

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Long-term marketable securities (primarily domestic government agency securities and corporate debt securities)	72,024	137,604
Total cash, cash equivalents and marketable securities	\$385,806	\$439,675



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For all investment securities, unrealized losses that are other than temporary are recognized in net income (loss). The Company does not hold these securities for speculative or trading purposes. During the three and nine months ended June 30, 2005, the Company sold shares of equity securities for cash proceeds of \$32.6 million and \$44.4 million, respectively, and realized gains on the sales of these securities of \$31.2 million and \$42.3 million, respectively. In July 2005, the Company sold the remaining 2.8 million shares of SiRF Technology Holdings, Inc. for cash proceeds of \$50.9 million and realized gains on the sales of these securities of \$49.0 million.

**2. Acquisitions*****Fiscal 2005******Acquisition of Paxonet Communications, Inc.***

On December 3, 2004, the Company acquired all of the outstanding capital stock of Paxonet Communications, Inc. (Paxonet), a privately held company headquartered in Fremont, California, with an engineering workforce primarily based in India.

The consideration for this purchase was \$14.8 million in cash. Net tangible assets acquired were \$0.4 million. Approximately \$0.7 million of the purchase price was allocated to unearned compensation representing the intrinsic value of unvested stock options exchanged in the transaction and the remainder to identifiable intangible assets and goodwill. The unearned compensation is being amortized to expense over the four year remaining vesting period of the stock options. A total of \$43,000 and \$101,000 of this unearned compensation was recognized as an expense in the three and nine months ended June 30, 2005, respectively. The identifiable intangible assets of \$1.4 million are being amortized on a straight-line basis over a period of two to eight years, with a weighted-average life of approximately six years. The \$12.4 million in goodwill is not deductible for tax purposes.

The Company also completed an asset acquisition in the three months ended March 31, 2005 which was not material to its consolidated financial statements.

The pro forma effects of these acquisitions were not material to the Company's results of operations for fiscal 2005 or 2004.

***Fiscal 2004******Acquisition of Amphion Semiconductor***

On June 29, 2004, the Company purchased all the outstanding capital stock of Amphion Semiconductor Limited (Amphion), a company located in Belfast, Northern Ireland specializing in developing video compression technology. The Company completed this strategic acquisition as a complement to existing products. The consideration for this purchase was \$20.0 million in cash, 600,000 shares of common stock (valued at \$6.0 million) and \$0.4 million in transaction costs. Net tangible assets acquired were \$2.4 million. The excess of the purchase price over the net tangible assets was assigned to developed technology of \$4.2 million and \$19.4 million to goodwill. The developed technology will be amortized on a straight-line basis over five years. The \$19.4 million in goodwill is not deductible for tax purposes.

Under the stock purchase agreement, the Company guaranteed the value of the shares issued to the former Amphion shareholders for a defined period through June 29, 2006 (subject to certain conditions and elections). The guaranty is subject to adjustment for any stock split, stock dividend, recapitalization, merger or similar transaction. In the event that the market price of the Conexant common stock does not equal or exceed \$10.00 for at least five consecutive trading days during this period, Conexant would be required to make an additional payment (in cash or additional shares of common stock at Conexant's option) to former Amphion shareholders for the difference between the \$10.00 and the market price per share of such shares as of specified dates. Consequently, the Company has valued the shares delivered to the former Amphion shareholders at the guaranteed value of \$10.00 per share, or a

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total of \$6.0 million. To the extent the Company is required to make an additional payment under the guaranty, the payment will not increase the total purchase price.

The terms of this acquisition include provisions under which the former shareholders of Amphion could receive additional consideration of up to \$3.0 million through December 31, 2005 if certain technology milestones are achieved. This contingent consideration has not been included in the purchase price allocation and if earned, such amounts will be capitalized as an addition to goodwill.

***Merger with GlobespanVirata, Inc.***

On February 27, 2004, the Company completed its merger with GlobespanVirata, with GlobespanVirata becoming a wholly-owned subsidiary of the Company. In May 2004, the GlobespanVirata, Inc. subsidiary was renamed Conexant, Inc., and hereinafter will be referred to as Conexant, Inc., and the overall business combination is hereinafter referred to as the Merger.

The Merger was accounted for as a purchase and the operating results of the former GlobespanVirata have been included in the Company's operations from the closing date.

A portion of the Merger purchase price was allocated to in process research and development (IPR&D). \$160.8 million was expensed upon completion of the Merger (as a charge not deductible for tax purposes) as it was determined that the underlying products had not reached technological feasibility, had no alternative uses and successful development was uncertain. The Company identified and valued IPR&D projects relating to the development of DSL and wireless networking products. The DSL projects represented 70% of the total IPR&D acquired. The estimated costs to complete for the DSL and wireless networking projects were approximately \$14.1 million and \$6.2 million, respectively. The fair values assigned to these projects were based on the income approach and used projected cash flows which were discounted at a rate of 19%. The discount rate was derived from a weighted-average cost of capital analysis, adjusted upwards to reflect additional risks inherent in the development process, including the probability of achieving technological success and market acceptance. Each of the IPR&D projects was analyzed considering technological innovations, the existence and utilization of core technology, the complexity, costs and time to complete the remaining development efforts, and stage of completion. The discount rate reflects the stage of completion and other risks inherent in the projects. The material risks associated with the incomplete projects are the ability to complete the items within the outlined timeframes and within the allocated cost guidelines, and ultimately to sell the products to end-users. As of June 30, 2005, the DSL related IPR&D projects were approximately 35% complete, 60% are expected to be completed by the end of calendar 2005, and 5% have been abandoned due to product roadmap and market changes. The wireless networking related IPR&D projects are approximately 50% complete and 50% are expected to be completed by the end of calendar 2005. Completion costs to date on all projects have been consistent with estimates made at the time of the Merger. However, revenue projections for the sale of DSL and wireless networking products have declined since the time of the Merger. See Net Revenues portion in Results of Operations section of Management's Discussion and Analysis for further discussion.

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**3. Supplemental Financial Statement Data***Marketable Securities*

Marketable securities consist of short-term investments and long-term investments, all of which are classified as available-for-sale securities as follows:

	Amortized Cost	Gross Unrealized Holding Gains	Gross Unrealized Holding Losses	Fair Value
<b>Short-term investments (in thousands):</b>				
<b>June 30, 2005:</b>				
Corporate debt securities	\$ 24,015	\$	\$ (3)	\$ 24,012
Domestic government agency securities	34,051		(2)	34,049
Equity securities	54,459	47,042	(6,276)	95,225
	\$ 112,525	\$ 47,042	\$ (6,281)	\$ 153,286
<b>September 30, 2004:</b>				
Mutual funds	\$ 10,837	\$	\$ (125)	\$ 10,712
Corporate debt securities	2,274		(3)	2,271
Equity securities	56,524	93,533		150,057
	\$ 69,635	\$ 93,533	\$ (128)	\$ 163,040

During the three and nine months ended June 30, 2005, the Company sold shares of equity securities for cash proceeds of \$32.6 million and \$44.4 million, respectively. The gains on sales of these securities were \$31.2 million and \$42.3 million, respectively.

The mutual fund holdings at September 30, 2004 were invested in adjustable rate mortgages and government agency securities.

	Amortized Cost	Gross Unrealized Holding Gains	Gross Unrealized Holding Losses	Fair Value
<b>Long-term investments (in thousands):</b>				
<b>June 30, 2005:</b>				
Domestic government agency securities	\$ 41,974	\$	\$ (232)	\$ 41,742
Corporate debt securities	30,564	1	(283)	30,282
	\$ 72,538	\$ 1	\$ (515)	\$ 72,024
<b>September 30, 2004:</b>				
Domestic government agency securities	\$ 105,956	\$	\$ (800)	\$ 105,156
Corporate debt securities	32,595		(147)	32,448
	\$ 138,551	\$	\$ (947)	\$ 137,604

The Company's long-term marketable securities principally have original contractual maturities from one to three years.

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***Inventories***

Inventories consist of the following (in thousands):

	<b>June 30, 2005</b>	<b>September 30, 2004</b>
Work-in-process	\$ 62,000	\$ 99,226
Finished goods.	41,491	95,528
	<b>\$ 103,491</b>	<b>\$ 194,754</b>

At June 30, 2005 and September 30, 2004, inventories are net of \$49.8 million and \$23.3 million, respectively, of allowances for excess and obsolete (E&O) inventories. In addition, at June 30, 2005, inventories are net of \$7.0 million in lower of cost or market reserves. Activity in the E&O inventory reserves for the three and nine months ended June 30, 2005 was as follows:

	<b>Three months ended June 30, 2005</b>	<b>Nine months ended June 30, 2005</b>
E&O reserves, beginning of period	\$ 53,302	\$ 23,319
Additions	2,131	31,296
Release upon sales of product	(1,298)	(2,299)
Scrap	(3,460)	(5,502)
Standards adjustments and other	(864)	2,997
E&O reserves, end of period	<b>\$ 49,811</b>	<b>\$ 49,811</b>

The Company has created an action plan at a product line level to scrap approximately 30% of the E&O products and is still in the process of evaluating the remaining reserved products. It is possible that some of these reserved products will be sold which will benefit gross margin in the period sold. During the three and nine months ended June 30, 2005, the Company sold \$1.3 million and \$2.3 million, respectively, of reserved products which benefited gross margin in the associated period.

The Company's products are used by communications electronics OEMs that have designed the products into communications equipment. For many of the products, the Company gains design wins through a lengthy sales cycle, which often includes providing technical support to the OEM customer. Moreover, once a customer has designed a particular supplier's components into a product, substituting another supplier's components often requires substantial design changes which involve significant cost, time, effort and risk. In the event of the loss of business from existing OEM customers, the Company may be unable to secure new customers for the existing products without first achieving new design wins. When the quantities of inventory on hand exceed foreseeable demand from existing OEM customers into whose products our products have been designed, the Company generally will be unable to sell the excess inventories to others, and the estimated realizable value of such inventories is generally zero.

On a quarterly basis, the Company assesses the net realizable value of its inventories. When the estimated average selling price, plus costs to sell the inventory falls below the inventory cost, inventory is adjusted to its current estimated market value. During the nine months ended June 30, 2005, the Company recorded \$18.9 million in inventory charges to adjust certain Wireless Networking products to their estimated market value. Increases to this inventory reserve may be required based upon actual average selling prices and changes to current estimates, which

would impact gross margin percentage in future periods. Activity in the lower of cost or market (LCM) inventory reserves for the three and nine months ended June 30, 2005 was as follows:

	<b>Three months ended June 30, 2005</b>	<b>Nine months ended June 30, 2005</b>
LCM reserves, beginning of period	\$ 11,093	\$
Additions		18,854
Release upon sales of product	(1,488)	(5,370)
Scrap		
Standards adjustments and other	(2,588)	(6,467)
LCM reserves, end of period	\$ 7,017	\$ 7,017

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***Goodwill***

During the first nine months of fiscal 2005, goodwill was adjusted as follows (in thousands):

Goodwill, September 30, 2004	\$708,544
Acquisitions	16,097
Adjustments to prior purchase price allocation (1)	(6,306)
 Goodwill, June 30, 2005	 \$718,335

- (1) In the Merger, the Company acquired a reserve for income tax contingencies for foreign income tax matters which arose due to items recorded in the income tax returns of the former GlobespanVirata subsidiaries. In the quarter ended December 31, 2004, a portion of this income tax contingency was settled with the taxing authorities, and as a result, the amount of the liability in excess of the settlement amount, or \$5.4 million, was reduced with a corresponding reduction to goodwill. In addition, in the quarter ended March 31, 2005,

as a result of subsequent decisions on the consolidation of facilities, the Company reduced certain restructuring and other facilities reserves established at the time of the Merger by a net of \$0.9 million. A corresponding reduction was made to goodwill.

### ***Intangible Assets***

Intangible assets consist of the following (in thousands):

	<b>June 30, 2005</b>			<b>September 30, 2004</b>		
	<b>Gross Asset</b>	<b>Accumulated Amortization</b>	<b>Net</b>	<b>Gross Asset</b>	<b>Accumulated Amortization</b>	<b>Net</b>
Developed technology	\$ 146,146	\$(47,033)	\$ 99,113	\$ 145,946	\$(25,359)	\$ 120,587
Customer base	4,660	(1,549)	3,111	2,050	(847)	1,203
Other intangible assets	21,888	(9,484)	12,404	20,908	(7,457)	13,451
	\$ 172,694	\$(58,066)	\$ 114,628	\$ 168,904	\$(33,663)	\$ 135,241

Intangible assets are amortized over a weighted-average period of approximately five years. Annual amortization expense is expected to be as follows (in thousands):

	<b>Remainder of</b>					
	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>Thereafter</b>
Amortization expense	\$ 7,918	\$30,701	\$29,801	\$29,334	\$13,831	\$3,043

### ***Mindspeed Warrant***

The Company has a warrant to purchase 30 million shares of Mindspeed Technologies, Inc. (Mindspeed) common stock at an exercise price of \$3.408 per share through June 2013. The Company accounts for the Mindspeed warrant as a derivative instrument, and changes in the fair value of the warrant are included in other (income) expense, net each period. At June 30, 2005, the aggregate fair value of the Mindspeed warrant included on the accompanying consolidated condensed balance sheet was \$11.2 million. The warrant was valued using a Black-Scholes model with terms for portions of the warrant varying from 1 to 5 years, expected volatility of 90%, a risk-free interest rate of 3.2% and no dividend yield. Given current market conditions, the Company has determined that at this time, it does not have the ability to liquidate a portion of the warrant in the next twelve months. Consequently, all amounts are reflected as long-term on the accompanying consolidated condensed balance sheet.

The valuation of this derivative instrument is subjective, and option valuation models require the input of highly subjective assumptions, including the expected stock price volatility. Changes in these assumptions can materially



affect the fair value estimate. The Company could, at any point in time, ultimately realize amounts significantly different than the carrying value.

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**Convertible Subordinated Notes**

At September 30, 2004 and June 30, 2005, the components of convertible subordinated notes are as follows (in thousands):

4.00% Convertible Subordinated Notes due February 2007 with a conversion price of \$42.43	\$ 515,000
4.25% Convertible Subordinated Notes due May 2006 with a conversion price of \$9.08	66,825
5.25% Convertible Subordinated Notes due May 2006 with a conversion price of \$22.26	130,000
Total	711,825
Less, current portion of convertible subordinated notes	(196,825)
Long- term portion of convertible subordinated notes	\$ 515,000

**Purchase and Sale-Leaseback**

In March 2005, the Company completed the purchase and sale-leaseback of two buildings in Newport Beach, California. In August 2004, the Company exercised its approximate \$60.0 million purchase option on these buildings under its then existing lease agreement. Concurrent with the payment of the \$60.0 million purchase option in March 2005, the Company sold the buildings to a third party for \$110.0 million. Net cash proceeds from this transaction, after closing costs of approximately \$1.0 million, were approximately \$49.0 million. The net deferred gain on the sale was \$43.6 million, excluding \$5.4 million of leasehold improvements and other property associated with these buildings.

The Company will continue to occupy one of the buildings under a ten year lease. The other building will be leased back by the Company for a period of 39 months, and Mindspeed will continue to occupy that space as a subtenant for the entire term of the lease. The net gain on the sale of \$43.6 million has been deferred and is included in other long-term liabilities on the accompanying consolidated condensed balance sheet, and will be recognized as a reduction to rent expense ratably over the terms of the respective leases.

**Other (Income) Expense, Net**

Other (income) expense, net consists of the following (in thousands):

	<b>Three months ended</b>		<b>Nine months ended</b>	
	<b>June 30, 2005</b>	<b>June 30, 2004</b>	<b>June 30, 2005</b>	<b>June 30, 2004</b>
Investment and interest income	\$ (2,182)	\$ (1,404)	\$ (3,956)	\$ (6,703)
Decrease in fair value of the conversion right under the Skyworks 15% convertible senior subordinated notes		17,837		6,292
Decrease in fair value of the Mindspeed warrant	16,085	60,924	14,804	38,379
Equity in (earnings) losses of equity method investees	2,127	(1,934)	8,587	(12,750)
Gains on sales of equity securities, investments and assets	(31,198)	(27,107)	(42,310)	(27,017)
Other	(442)	(471)	(492)	768
Other (income) expense, net	\$(15,610)	\$ 47,935	\$(23,367)	\$ (1,031)

During the three and nine months ended June 30, 2005, the Company sold shares of equity securities for cash proceeds of \$32.6 million and \$44.4 million, respectively. The gain on sales of these securities was \$31.2 million and \$42.3 million, respectively.

During the nine months ended June 30, 2004, an unrelated party repaid a \$30.0 million note issued in connection with a previous equity investment in Jazz Semiconductor, Inc., in which the Company owns a 38% interest. In accordance with Staff Accounting Bulletin No. 51, the Company recognized an \$11.4 million gain upon the payment of this note, which is included in equity in earnings of equity method investees.

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**4. Skyworks Notes**

In November 2002, the Company restructured its previous financing agreements with Skyworks Solutions, Inc. (Skyworks) whereby Skyworks repaid \$105.0 million of the principal amount and all accrued interest owed to the Company under the \$150.0 million promissory notes issued by Skyworks and certain Skyworks subsidiaries and collateralized by substantially all of the assets of Skyworks (the Term Notes), and the remaining principal amount of the Term Notes was exchanged for \$45.0 million principal amount of the Skyworks 15% convertible senior subordinated notes with a maturity date of June 30, 2005. At the same time, Skyworks also repaid all amounts outstanding under the previous credit facility, the credit facility was cancelled and the Company released all security interests in Skyworks' assets and properties.

The Company received a notice dated April 22, 2004 from Skyworks advising that on May 12, 2004, Skyworks would redeem in full the 15% convertible senior subordinated notes held by the Company. The Company exercised its right to convert all of the notes into shares of Skyworks common stock prior to the scheduled redemption date at the conversion price of \$7.87 per share. On May 10, 2004, the Company received 5.7 million shares of Skyworks common stock in full satisfaction of the notes.

**5. Commitments and Contingencies*****Legal Matters***

Certain claims have been asserted against the Company, including claims alleging the use of the intellectual property rights of others in certain of the Company's products. The resolution of these matters may entail the negotiation of a license agreement, a settlement, or the adjudication of such claims through arbitration or litigation. See Note 7- Special Charges. The outcome of litigation cannot be predicted with certainty and some lawsuits, claims or proceedings may be disposed of unfavorably to the Company. Many intellectual property disputes have a risk of injunctive relief and there can be no assurance that a license will be granted. Injunctive relief could have a material adverse effect on the financial condition or results of operations of the Company. Based on its evaluation of matters which are pending or asserted and taking into account the Company's reserves for such matters, management believes the disposition of such matters will not have a material adverse effect on the financial condition, results of operations, or cash flows of the Company.

***IPO Litigation.*** In November 2001, Collegeware Asset Management, LP, on behalf of itself and a putative class of persons who purchased the common stock of GlobeSpan, Inc., (GlobeSpan, Inc. later became GlobespanVirata, Inc., and is now the Company's Conexant, Inc. subsidiary) between June 23, 1999 and December 6, 2000, filed a complaint in the U.S. District Court for the Southern District of New York alleging violations of federal securities laws by the underwriters of GlobeSpan, Inc.'s initial and secondary public offerings as well as by certain GlobeSpan, Inc. officers and directors. The complaint alleges that the defendants violated federal securities laws by issuing and selling GlobeSpan, Inc.'s common stock in the initial and secondary offerings without disclosing to investors that the underwriters had (1) solicited and received undisclosed and excessive commissions or other compensation and (2) entered into agreements requiring certain of their customers to purchase the stock in the aftermarket at escalating prices. The complaint seeks unspecified damages. The complaint was consolidated with class actions against approximately 300 other companies making similar allegations regarding the public offerings of those companies during 1998 through 2000. In June 2003, Conexant, Inc. and the named officers and directors entered into a memorandum or understanding outlining a settlement agreement with the plaintiffs that will, among other things, result in the dismissal with prejudice of all the claims against the former GlobeSpan, Inc. officers and directors. The final settlement was executed in June 2004. On February 15, 2005, the Court issued a decision certifying a class action for settlement purposes and granting preliminary approval of the settlement, subject to modification of certain bar orders contemplated by the settlement. The bar orders have since been modified. The settlement remains subject to a number of conditions and final approval. It is possible that the settlement will not be approved. Even if the settlement is approved, individual class members will have an opportunity to opt out of the class and to file their own lawsuits, and some may do so. In either event, the Company does not anticipate that the ultimate outcome of this litigation will

have a material adverse impact on the Company's financial condition, results of operations, or cash flows.

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**Texas Instruments, Inc.** The Company's Conexant, Inc. subsidiary has been involved in a dispute with Texas Instruments, Inc. (Texas Instruments) over a group of patents (and related foreign patents) that Texas Instruments alleges are essential to certain industry standards for implementing ADSL technology. On June 12, 2003, Conexant, Inc. filed a complaint against Texas Instruments, Stanford University and its Board of Trustees, and Stanford University OTL, LLC (collectively, the Defendants) in the U.S. District Court of New Jersey. The complaint asserts, among other things, that the Defendants have violated the antitrust laws by creating an illegal patent pool, by manipulating the patent process and by abusing the process for setting industry standards related to ADSL technology. The complaint also asserts that the Defendants' patents relating to ADSL are unenforceable, invalid and/or not infringed by Conexant, Inc. products. Conexant, Inc. is seeking, among other things, (i) a finding that the Defendants have violated the federal antitrust laws and treble damages based upon such a finding, (ii) an injunction prohibiting the Defendants from engaging in anticompetitive practices, (iii) a declaratory judgment that the claims of the Defendants ADSL patents are invalid, unenforceable, void, and/or not infringed by Conexant, Inc. and (iv) an injunction prohibiting the Defendants from pursuing patent litigation against Conexant, Inc. and its customers. On August 11, 2003 and September 9, 2003, the Defendants answered the complaint, denied Conexant, Inc.'s claims and filed counterclaims alleging that Conexant, Inc. has infringed certain of their ADSL patents. In addition to other relief, the Defendants are seeking to collect damages for alleged past infringement and to enjoin Conexant, Inc. from continuing to use the Defendant's ADSL patents. Although the Company believes that Conexant, Inc. has strong arguments in favor of its position in this dispute, it can give no assurance that Conexant, Inc. will prevail on any of these grounds in litigation. If any such litigation is adversely resolved, Conexant, Inc. could be held responsible for the payment of damages and/or future royalties and/or have the sale of certain of Conexant, Inc. products stopped by an injunction, any of which could have a material adverse effect on the Company's business, financial condition and results of operations.

**Class Action Suits.** In December 2004 and January 2005, the Company and certain current and former officers were named as defendants in several complaints filed on behalf of all persons who purchased Company common stock during a specified class period. These suits were filed in the U.S. District Court of New Jersey (New Jersey cases) and the U.S. District Court for the Central District of California (California cases), alleging that the defendants violated the Securities Exchange Act of 1934 (the Exchange Act) by allegedly disseminating materially false and misleading statements and/or concealing material adverse facts. The California cases have now been consolidated with the New Jersey cases so that all of the class action suits, now known as *Witriol v. Conexant, et al.*, are being heard in the U.S. District Court of New Jersey by the same judge. The defendants believe these charges are without merit and intend to vigorously defend the litigation.

In addition, in February 2005, the Company and certain of its current and former officers and the Company's Employee Benefits Plan Committee were named as defendants in *Graden v. Conexant, et al.*, a lawsuit filed on behalf of all persons who were participants in the Company's 401(k) Plan ( Plan ) during a specified class period. This suit was filed in the U.S. District Court of New Jersey and alleges that the defendants breached their fiduciary duties under the Employee Retirement Income Security Act, as amended, to the Plan and the participants in the Plan. The defendants believe these charges are without merit and intend to vigorously defend the litigation.

**Shareholder Derivative Suits.** In January 2005, the Company and certain current and former directors and officers were named as defendants in purported shareholder derivative actions (now consolidated) in California Superior Court for the County of Orange, alleging that the defendants breached their fiduciary duties, abused control, mismanaged the Company, wasted corporate assets and unjustly enriched themselves. A similar lawsuit was filed in U.S. District Court of New Jersey in May 2005. On July 28, 2005, the court approved a stay of the action filed in California pending the outcome of the motion to dismiss in *Witriol v. Conexant, et al.* The Company has negotiated a similar agreement with the plaintiffs in the New Jersey case, which is subject to approval by the court. Pursuant to the stay agreements, in the event that the parties in the *Witriol* case engage in any negotiations, plaintiffs' counsel in the derivative cases will be allowed to participate. The defendants believe the charges in these cases are without merit and intend to vigorously

defend the litigation.

***Other***

The Company has been designated as a potentially responsible party and is engaged in groundwater remediation at one Superfund site located at a former silicon wafer manufacturing facility and steel fabrication plant in Parker Ford, Pennsylvania formerly occupied by the Company. In addition, the Company is engaged in remediation of groundwater contamination at its former Newport Beach, California wafer fabrication facility. Management

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currently estimates the aggregate remaining costs for these remediations to be approximately \$2.9 million and has accrued for these costs as of June 30, 2005.

The Company leases certain facilities and equipment under non-cancelable operating leases which expire at various dates through 2021 and contain various provisions for rental adjustments including, in certain cases, adjustments based on increases in the Consumer Price Index. The leases generally contain renewal provisions for varying periods of time. Rental expense under operating leases was approximately \$17.0 million and \$15.5 million for the nine months ended June 30, 2005 and 2004, respectively.

At June 30, 2005, future minimum lease payments under operating leases, excluding any sublease income, were as follows (in thousands):

**Fiscal Year**

2005 remaining 3 months	\$ 8,550
2006	29,382
2007	24,732
2008	20,051
2009	17,109
Thereafter	105,750
 Total future minimum lease payments	 \$205,574

At June 30, 2005, the Company has many sublease arrangements on operating leases for terms ranging from near term to approximately 6 years. Aggregate scheduled sublease income based on current terms is approximately \$19.7 million.

The summary of future minimum lease payments includes an aggregate gross amount of \$40.9 million of lease obligations that principally expire through fiscal 2021, which have been accrued for in connection with the Company's reorganization and restructuring actions (see Note 7) and previous actions taken by GlobespanVirata prior to the Merger.

At June 30, 2005, the Company is contingently liable for approximately \$8.3 million in operating lease commitments on facility leases that were assigned to Mindspeed and Skyworks at the time of their separation from the Company. In connection with acquisitions in fiscal 2004 and 2005, the Company is contingently liable for an aggregate of up to \$6.0 million of milestone and earn-out payments through January 2006. In addition, see Note 2 regarding the contingent amounts for the stock price guarantee in the Amphion acquisition.

In connection with certain non-marketable equity investments, the Company may be required to invest up to an additional \$5.9 million as of June 30, 2005.

The Company has made commitments to certain employees in the amount of \$1.3 million as of June 30, 2005. Such amounts will be earned and paid over the next six months.



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**6. Comprehensive Loss**

Comprehensive loss is as follows (in thousands):

	<b>Three months ended June 30,</b>		<b>Nine months ended June 30,</b>	
	<b>2005</b>	<b>2004</b>	<b>2005</b>	<b>2004</b>
Net loss	\$(32,166)	\$(71,426)	\$(226,071)	\$(174,158)
Other comprehensive income (loss):				
Foreign currency translation adjustments	(481)	(556)	398	346
Change in unrealized gains on available-for-sale securities	29,387	65,762	(13,964)	67,441
Reclassification adjustment for realized gains on available-for-sale securities included in net loss	(26,987)		(38,247)	
Minimum pension liability adjustments	69	87	207	260
Effect of income taxes				172
Other comprehensive income (loss)	1,988	65,293	(51,606)	68,219
Comprehensive loss	\$(30,178)	\$ (6,133)	\$(277,677)	\$(105,939)

The components of accumulated other comprehensive income are as follows (in thousands):

	<b>June 30, 2005</b>	<b>September 30, 2004</b>
Foreign currency translation adjustments	\$ (2,808)	\$ (3,206)
Unrealized gains on available-for-sale securities	40,247	92,458
Minimum pension liability adjustments	(6,494)	(6,701)
Accumulated other comprehensive income	\$30,945	\$ 82,551

**7. Special Charges**

Special charges consist of the following (in thousands):

	<b>Three months ended June 30,</b>		<b>Nine months ended June 30,</b>	
	<b>2005</b>	<b>2004</b>	<b>2005</b>	<b>2004</b>
Asset impairments	\$ 29	\$2,508	\$ 3,492	\$ 4,534
Restructuring charges	6,731	3,627	24,470	4,075
Integration charges	1,649	1,565	6,760	4,168
Other		594	6,540	1,636

\$8,409	\$8,294	\$41,262	\$14,413
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***Asset Impairments***

During the nine months ended June 30, 2005, the Company recorded asset impairment charges of \$3.5 million related primarily to leasehold improvements on operating properties that have been or will be vacated as part of the Company's restructuring actions.

During the nine months ended June 30, 2004 in connection with the Merger, the Company recorded asset impairment charges of \$4.5 million related to various Conexant operating assets which were determined to be redundant and no longer required as a result of the Merger. These assets have been abandoned.

***Restructuring Charges***

The Company has implemented a number of cost reduction initiatives since late fiscal 2001 to improve its operating cost structure. The cost reduction initiatives included workforce reductions, and the closure or consolidation of certain facilities, among other actions. The costs and expenses associated with the restructuring activities, except for the liabilities associated with the 2004 Reorganization Plan that related to the employees and facilities of Conexant, Inc., are included in special charges in the accompanying consolidated condensed statements of operations. The costs and expenses resulting from the 2004 Reorganization Plan which related to the employees and facilities of

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Conexant, Inc. have been recorded as acquired liabilities in the Merger and included as part of the purchase price allocation in accordance with EITF 95-3 and SFAS No. 141. Subsequent actions that impacted the employees and facilities of Conexant, Inc. have been included in special charges on the Company's statements of operations.

*2005 Restructuring Action* In November 2004, the Company announced additional plans to reduce its operating expense level by the end of the fourth fiscal quarter of 2005. The components of this plan are a shift of product development resources to lower-cost regions and cost savings from continued Merger-related sales, general and administrative consolidation. During the nine months ended June 30, 2005, the Company announced several other site closures and further workforce reductions. In total, the Company notified approximately 255 employees of their involuntary termination, including approximately 175 domestic and 80 international employees. Certain employees were offered relocation opportunities. As of June 30, 2005, some of these employees have left the Company, and others will be transitioning their work over the next three months. The workforce reductions affected employees in all areas of the business. During the nine months ended June 30, 2005, the Company recorded total charges of \$17.8 million based on the estimates of the cost of severance benefits for the affected employees, and the estimated relocation benefits for those employees who have been offered and have commenced the relocation process. The Company will charge an additional \$1.3 million to restructuring expense in the fourth fiscal quarter as certain severance benefits are earned. Additionally, the Company has recorded restructuring charges of \$4.9 million in the first nine months of 2005 relating to the consolidation of certain facilities under non-cancelable leases which were vacated. The facility charges were determined in accordance with the provisions of SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*. As a result, the Company recorded the present value of the future lease obligations, in excess of the expected future sublease income, using a discount rate of 8.0%, and will accrete the remaining approximate \$2.0 million into expense over the remaining life of the leases. The accrual for facility charges includes a \$1.0 million non-cash reclassification of a portion of the deferred gain on the previous sale-leaseback of the facility, which has now been partially vacated.

Activity and liability balances recorded as part of the 2005 Restructuring Action through June 30, 2005 were as follows (in thousands):

	<b>Workforce reductions</b>	<b>Facility and other</b>	<b>Total</b>
Charged to costs and expenses	\$ 6,073	\$4,006	\$10,079
Non-cash items	(22)	979	957
Cash payments	(3,333)		(3,333)
Restructuring balance, December 31, 2004	2,718	4,985	7,703
Charged to costs and expenses	5,936	74	6,010
Cash payments	(2,819)	(168)	(2,987)
Restructuring balance, March 31, 2005	5,835	4,891	10,726
Charged to costs and expenses	5,837	864	6,701
Non-cash items	(23)		(23)
Cash payments	(3,937)	(203)	(4,140)
Restructuring balance, June 30, 2005	\$ 7,712	\$5,552	\$13,264

*2004 Restructuring Actions* The Company approved several restructuring plans during fiscal 2004. In connection with the Merger, the Company began to formulate plans which included workforce reductions and facility consolidation actions. These plans were communicated at the time of the Merger and have been completed (the 2004 Merger

Related Restructuring and Reorganization Plans). During the fourth fiscal quarter of 2004, the Company announced additional workforce reduction and facility consolidation actions in response to lower than anticipated revenue levels. In connection with the Merger, the Company began to formulate the 2004 Merger Related Reorganization Plan which consisted primarily of workforce reductions to eliminate redundant positions and consolidation of worldwide facilities. The portions of the plan that pertained to Conexant, Inc. employees and facilities were recorded as acquired liabilities in the Merger and included as part of the purchase price allocation, in accordance with EITF No. 95-3 and SFAS No. 141. This plan consisted of an involuntary workforce reduction which affected approximately 35 employees of Conexant, Inc. These employees were located in the United States in sales and administrative functions. The charge associated with these workforce reductions of approximately \$1.3 million was based upon estimates of the severance and fringe benefits for the affected employees, in addition to relocation benefits for

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others. The facility consolidation plan resulted in an initial charge of \$13.5 million and included assumptions regarding sublease rates and time periods and other costs to prepare and sublease the applicable spaces. Additionally, at the date of the Merger, there had been a decline in the real estate market in certain geographic regions in which Conexant, Inc. had leased facilities. A portion of the facilities related charges represent adjustments to the fair market value rates of those leases. These non-cancelable lease commitments range from near term to 17 years in length. In fiscal 2004, the Company reduced the original facility consolidation charge by approximately \$3.6 million and increased the workforce related charge by approximately \$0.2 million as a result of finalizing the 2004 Merger Related Reorganization Plan and recorded these changes as adjustments to the purchase price allocation (goodwill). In the quarter ended March 31, 2005, as a result of finalizing facilities consolidation actions, the Company reduced its facilities reserves by a total of \$1.2 million as adjustments to the purchase price allocation (goodwill). Activity and liability balances recorded as part of the 2004 Merger Related Reorganization Plan pertaining to Conexant, Inc. employees and facilities through June 30, 2005 were as follows (in thousands):

	<b>Workforce reductions</b>	<b>Facility and other</b>	<b>Total</b>
Recorded in purchase price allocation	\$ 1,300	\$ 13,509	\$ 14,809
Adjusted to purchase price allocation	210	(3,554)	(3,344)
Cash payments	(536)	(788)	(1,324)
Restructuring balance, September 30, 2004	974	9,167	10,141
Cash payments	(277)	(273)	(550)
Restructuring balance, December 31, 2004	697	8,894	9,591
Adjusted to purchase price allocation		(1,226)	(1,226)
Cash payments	(444)	(241)	(685)
Restructuring balance, March 31, 2005	253	7,427	7,680
Cash payments	(201)	(166)	(367)
Restructuring balance, June 30, 2005	\$ 52	\$ 7,261	\$ 7,313

The portion of the 2004 restructuring actions pertaining to Conexant Systems, Inc. employees and facilities was recorded to special charges during fiscal 2004 (the 2004 Merger Related Restructuring Plan). Approximately 90 employees in the sales and administrative and information technology areas were involuntarily terminated shortly after the completion of the Merger, resulting in initial charges of \$1.9 million, which was based upon estimates of severance benefits for the affected employees. These employees left the Company through December 2004.

Additionally, in fiscal 2004, the Company recorded restructuring charges of \$1.9 million relating to the consolidation of certain facilities under non-cancelable leases which were vacated. In the quarter ended March 31, 2005, one additional facility was vacated which resulted in an additional charge of \$0.1 million in accordance with SFAS No. 146.

During the fourth fiscal quarter of 2004, the Company announced additional workforce reduction actions in response to lower than anticipated revenue levels. The Company recorded an additional \$5.1 million (for a total of \$7.0 million in fiscal 2004) based on the estimates of the cost of severance benefits for the affected employees. An additional \$1.6 million of net severance benefits were earned in the nine months ended June 30, 2005 based on the passage of time in the notification period, net of resignations and favorable adjustments of final settlement amounts. In total, the Company notified approximately 230 employees of their involuntary termination, including approximately 180

domestic and 50 international employees. The workforce reductions affected employees in all areas of the business and are complete as of June 30, 2005.

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Activity and liability balances recorded as part of the 2004 Merger Related Restructuring Plan pertaining to Conexant Systems, Inc. employees and facilities and the additional fourth fiscal quarter of 2004 restructuring action through June 30, 2005 were as follows (in thousands):

	<b>Workforce reductions</b>	<b>Facility and other</b>	<b>Total</b>
Charged to costs and expenses	\$ 7,066	\$ 1,877	\$ 8,943
Cash payments	(2,368)	(281)	(2,649)
Restructuring balance, September 30, 2004	4,698	1,596	6,294
Charged to costs and expenses	1,892		1,892
Cash payments	(2,034)	(197)	(2,231)
Restructuring balance, December 31, 2004	4,556	1,399	5,955
Charged to costs and expenses	(350)	108	(242)
Cash payments	(2,805)	(235)	(3,040)
Restructuring balance, March 31, 2005	1,401	1,272	2,673
Charged to costs and expenses	30		30
Cash payments	(627)	(205)	(832)
Restructuring balance, June 30, 2005	\$ 804	\$ 1,067	\$ 1,871

*2003 Corporate Restructuring Plan* In the fourth quarter of fiscal 2003, the Company initiated a workforce reduction, closed a design center and consolidated some facilities. The Company involuntarily terminated employees in the sales and administration areas and recorded charges aggregating \$1.2 million based upon estimates of the cost of severance benefits for the affected employees. The Company also recorded restructuring costs of \$2.8 million relating to the consolidation of certain facilities under non-cancelable leases which were vacated.

Activity and liability balances related to the 2003 Corporate Restructuring Plan through June 30, 2005 were as follows (in thousands):

	<b>Workforce reductions</b>	<b>Facility and other</b>	<b>Total</b>
Charged to costs and expenses	\$ 1,181	\$ 2,830	\$ 4,011
Cash payments	(364)		(364)
Restructuring balance, September 30, 2003	817	2,830	3,647
Charged to costs and expenses	350	98	448
Expense reversal	(81)		(81)
Cash payments	(1,086)	(933)	(2,019)
Restructuring balance, September 30, 2004		1,995	1,995
Cash payments		(38)	(38)
Restructuring balance, December 31, 2004		1,957	1,957
Cash payments		(44)	(44)

Restructuring balance, March 31, 2005		1,913	1,913
Cash payments		(110)	(110)
Restructuring balance, June 30, 2005	\$	\$1,803	\$ 1,803

*2002 Corporate and Manufacturing Restructuring Plan* During fiscal 2002, the Company initiated a reduction of its workforce throughout its operations primarily as a result of the divestiture of its Newport Beach wafer fabrication operations and the spin-off and merger of the Company's wireless communications business with Alpha Industries, Inc. to form Skyworks. In connection with the fiscal 2002 corporate and manufacturing restructuring actions, the Company terminated approximately 120 employees and recorded charges aggregating \$2.4 million based upon estimates of the cost of severance benefits for the affected employees. The Company completed these actions in fiscal 2002. In addition, the Company recorded restructuring charges of \$12.5 million for costs associated with the consolidation of certain facilities and commitments under license obligations that management determined would not be used in the future.

As part of the 2002 Corporate and Manufacturing Restructuring Plan, during the first quarter of fiscal 2003, the Company initiated a further workforce reduction affecting 58 employees and recorded additional charges of \$1.9 million based upon estimates of the cost of severance benefits for the affected employees. During the third quarter of fiscal 2003, the Company revised its estimate of liabilities for severance benefits and facility costs due to



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unfavorable sublease experience to date, and charged an additional \$1.5 million to restructuring. In the fourth quarter of 2003, the Company reversed \$1.1 million of the estimated cost to settle the remaining commitment under a license obligation after its favorable resolution, and increased the estimate of remaining facility costs due to unfavorable sublease experience.

Activity and liability balances related to the 2002 Corporate and Manufacturing Restructuring Plan through June 30, 2005 were as follows (in thousands):

	<b>Workforce reductions</b>	<b>Facility and other</b>	<b>Total</b>
Charged to costs and expenses	\$ 2,437	\$12,519	\$14,956
Cash payments	(1,664)	(431)	(2,095)
Restructuring balance, September 30, 2002	773	12,088	12,861
Charged to costs and expenses	2,898	888	3,786
Expense reversal		(1,100)	(1,100)
Cash payments	(3,173)	(3,930)	(7,103)
Restructuring balance, September 30, 2003	498	7,946	8,444
Expense reversal	(46)		(46)
Cash payments	(452)	(3,949)	(4,401)
Restructuring balance, September 30, 2004		3,997	3,997
Cash payments		(998)	(998)
Restructuring balance, December 31, 2004		2,999	2,999
Cash payments		(1,072)	(1,072)
Restructuring balance, March 31, 2005		1,927	1,927
Cash payments		(899)	(899)
Restructuring balance, June 30, 2005	\$	\$ 1,028	\$ 1,028

Through June 30, 2005, the Company has paid an aggregate of \$57.7 million in connection with all of its restructuring plans and has a remaining accrued restructuring balance of \$25.3 million. The Company expects to pay the amounts accrued for the workforce reductions through fiscal 2005 and 2006 and expects to pay the obligations for the non-cancelable lease and other commitments over their respective terms, which expire through fiscal 2021. Cash payments to complete the restructuring actions will be funded from available cash reserves and funds from product sales, and are not expected to significantly impact the Company's liquidity.

**Integration Charges**

During the three and nine months ended June 30, 2005 and 2004, the Company recognized \$1.6 million and \$6.8 million, and \$1.6 million and \$4.2 million, respectively, of costs committed as a result of the integration efforts of the employees, customers, operations and other business aspects related to the Merger.

**Other**

Other special charges of \$6.5 million in the nine months ended June 30, 2005 consists of \$3.2 million for settlements of legal matters, \$2.3 million of non-employee stock option and warrant modification charges and \$1.0 million of other special charges.

Other special charges in the three months ended June 30, 2004 consisted of \$0.6 million in stock option modification charges and, in addition, the nine months ended June 30, 2004 also included \$1.0 million of one-time executive bonuses which were contractually committed in the closing of the Merger.

**8. Segment Information**

SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information, establishes standards for the way that public business enterprises report information about operating segments in annual consolidated financial statements. Although we had four operating segments at June 30, 2005, under the aggregation criteria set forth in SFAS No. 131, we only operate in one reportable operating segment, broadband communications.

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Under SFAS No. 131, two or more operating segments may be aggregated into a single operating segment for financial reporting purposes if aggregation is consistent with the objective and basic principles of SFAS No. 131, if the segments have similar economic characteristics, and if the segments are similar in each of the following areas:

the nature of products and services;

the nature of the production processes;

the type or class of customer for their products and services; and

the methods used to distribute their products or provide their services.

The Company meets each of the aggregation criteria for the following reasons:

the sale of semiconductor products is the only material source of revenue for each of its four operating segments;

the products sold by each of its operating segments use a similar standard manufacturing process;

the products marketed by each of its operating segments are sold to similar customers; and

all of its products are sold through internal sales force and common distributors.

Because the Company meets each of the criteria set forth above and each of its operating segments has similar economic characteristics, the Company aggregates its results of operations in one reportable operating segment.

Net revenues by geographic area, based upon country of destination, are as follows (in thousands):

	<b>Three months ended</b>		<b>Nine months ended</b>	
	<b>June 30,</b>		<b>June 30,</b>	
	<b>2005</b>	<b>2004</b>	<b>2005</b>	<b>2004</b>
Americas	\$ 24,490	\$ 29,499	\$ 64,196	\$ 77,442
Asia-Pacific	160,989	215,797	399,046	554,457
Europe, Middle East and Africa	11,985	22,321	44,581	56,832
	\$197,464	\$267,617	\$507,823	\$688,731

The Company believes a portion of the products sold to original equipment manufacturers (OEMs) and third-party manufacturing service providers in the Asia-Pacific region are ultimately shipped to end-markets in the Americas and Europe. For each of the three and nine months ended June 30, 2005, and the three and nine months ended June 30, 2004, no customer accounted for 10% or more of net revenues.

**9. Guarantees**

The Company has made guarantees and indemnities, under which it may be required to make payments to a guaranteed or indemnified party, in relation to certain transactions. In connection with the Company's spin-off from Rockwell International Corporation (now named Rockwell Automation, Inc.), the Company assumed responsibility for all contingent liabilities and then current and future litigation (including environmental and intellectual property proceedings) against Rockwell or its subsidiaries in respect of the operations of the semiconductor systems business of Rockwell. In connection with the Company's contribution of certain of its manufacturing operations to Jazz Semiconductor, Inc., the Company agreed to indemnify Jazz for certain environmental matters and other customary divestiture-related matters. In connection with the sales of its products, the Company provides intellectual property indemnities to its customers. In connection with certain facility leases, the Company has indemnified its lessors for certain claims arising from the lease. The Company indemnifies its directors and officers to the maximum extent

permitted under the laws of the State of Delaware. The duration of the guarantees and indemnities varies, and in certain cases is indefinite. The guarantees and indemnities to customers in connection with product sales generally are subject to limits based upon the amount of the related product sales. The majority of other guarantees and indemnities do not provide for any limitation of the maximum potential future payments the Company could be obligated to make. The Company has not recorded any liability for guarantees and indemnities related to product sales in the accompanying consolidated balance sheets. Product warranty costs are not significant.

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**10. Stock Option Exchange Program**

On November 12, 2004, the Company commenced an offer to its employees to voluntarily exchange certain outstanding stock options. Under the terms of the offer, employees holding stock options having an exercise price equal to or greater than \$5.00 per share could exchange their options for new options to purchase an equal number of shares of the Company's common stock (subject to adjustment in certain circumstances). Employees accepting the exchange offer were also required to exchange all options granted within six months of the exchange offer, regardless of the exercise price. The offering period expired on December 13, 2004 and approximately 32.7 million common stock options, with a weighted-average exercise price of \$8.00 per share, were tendered to the Company, accepted and cancelled. The Company offered to grant new options to the affected employees, on a one-for-one basis, at a date that was at least six months and one day after the acceptance of the old options for exchange and cancellation. The exercise price of the new options was equal to the closing market price of Company common stock on such date. If the cancelled options were granted on or before December 31, 2002 or the eligible employee is a senior executive of the Company, the new options will vest in three equal installments on the first, second and third anniversaries of the grant date; otherwise the new options will vest 50% on the first anniversary of the grant date and 25% on each of the second and third anniversaries of the grant date.

On June 14, 2005, the Company granted new options to purchase an aggregate of 31.0 million shares of its common stock at an exercise price of \$1.49 per share (based on the closing market price of the Company's common stock on the grant date), with vesting provisions as described above.

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

This information should be read in conjunction with our unaudited consolidated condensed financial statements and the notes thereto included in this Quarterly Report, and our audited consolidated financial statements and notes thereto and Management's Discussion and Analysis of Financial Condition and Results of Operations contained in our Annual Report on Form 10-K for the fiscal year ended September 30, 2004.

Except where otherwise noted, this discussion of our financial condition and results of operations represents our current operations, which include the GlobespanVirata, Inc. business from February 28, 2004 following the completion of our merger with GlobespanVirata, Inc. (the Merger).

We are a leading provider of integrated circuits and software for broadband communications solutions addressing consumer, business enterprise and service provider markets. Our expertise in mixed-signal processing allows us to deliver semiconductor devices and complete integrated systems that connect the client, or end-customer, side of personal communications access products such as PCs, set-top boxes, residential gateways and game consoles to audio, video, voice and data services over broadband wire line communications networks, including virtually all varieties of digital subscriber line (DSL), cable and Ethernet networks, over wireless local area networks (LAN) and over direct broadcast satellite, terrestrial and fixed wireless systems. We also deliver highly integrated, system-level solutions for telephone company central office equipment, such as DSL access multiplexers (DSLAMs) used in the provisioning of broadband audio, video, voice and data services. Our dial-up access products include a broad portfolio of modem chipsets and software for desktop and notebook PC applications as well as embedded equipment applications including fax machines, multifunction peripherals (MFPs), point-of-sale (POS) terminals, set-top boxes, gaming consoles and Internet terminals. Our wide variety of wireless networking chipsets and reference designs enable wireless connectivity in notebooks, PDAs, digital cameras, MP3 players and other handheld networking appliances in the home and business enterprise environments. And our media processing solutions include silicon tuners, demodulators and a variety of broadcast audio and video decoder and encoder devices that enable the capture, display, storage, playback and transfer of audio and video content in consumer-oriented products such as PCs, set-top boxes, gaming consoles, personal video recorders and digital versatile disk (DVD) applications. We operate in one reportable business segment.

We market and sell our semiconductor products and system solutions directly to leading original equipment manufacturers (OEMs) of communication electronics products, and indirectly through electronic components distributors. We also sell our products to third-party electronic manufacturing service providers, who manufacture products incorporating our semiconductor products for OEMs. Sales to distributors and other resellers accounted for approximately 28% of net revenues in the first nine months of fiscal 2005, as compared to 35% for the similar period of fiscal 2004. No customer accounted for 10% of our net revenues in the first nine months of fiscal 2005. Our top 20 customers accounted for approximately 65% of net revenues for the first nine months of fiscal 2005. Revenues derived from customers located in the Asia-Pacific region, the Americas, and Europe were 79%, 13%, and 8%, respectively, of our net revenues for the first nine months of fiscal 2005. We believe a portion of the products we sell to OEMs and third-party manufacturing service providers in the Asia-Pacific region are ultimately shipped to end-markets in the Americas and Europe.

**Overview of Expense Reduction Initiatives**

Since the completion of the Merger in the March 2004 quarter, we have announced several workforce reductions and facilities consolidation actions in order to achieve operational efficiencies. In the fourth quarter of fiscal 2004, we announced additional workforce reductions to implement further Merger synergies and to align our operating expenses to lower revenue forecasts. These actions have been completed. In November 2004, we announced a plan to reduce quarterly operating expenses by an additional \$15.0 million. The primary drivers of the expense reductions are

expected to be an increasing shift of product development resources to lower-cost regions and cost savings from continued Merger-related selling, general and administrative consolidation. In December 2004, we completed the acquisition of Paxonet Communications, a semiconductor product development company with an experienced and lower-cost engineering team based in India. As a result of this acquisition and organic growth, we have more than tripled our headcount in India to approximately 540 engineers since the end of fiscal 2004.

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In the March and June quarters of fiscal 2005, we launched additional sets of headcount reduction actions, and closed additional operating sites, to bring us closer to our operating expense objectives. See Note 7 of Notes to Consolidated Condensed Financial Statements for further information. The cost savings of these actions are expected to be fully reflected in the quarter ending December 31, 2005. We continuously evaluate our business in light of current market and competitive conditions to ensure that our operating expenses are in line with our expected revenue forecasts. As a result, future periods may require further actions to reduce operating expenses. We do not believe that these actions have or will inhibit our ability to invest in appropriate levels of research and development.

**Results of Operations****Net Revenues**

	Three months ended			Change	Change
	June 30, 2005	March 31, 2005	June 30, 2004	from March 2005 Quarter	from June 2004 Quarter
(in millions)					
Net revenues	\$197.5	\$169.7	\$267.6	16%	(26)%

	Nine months ended		Change
	June 30, 2005	June 30, 2004	
(in millions)			
Net revenues	\$507.8	\$688.7	(26)%

We recognize revenue when (i) the risk of loss has been transferred to the customer, (ii) price and terms are fixed, (iii) no significant vendor obligation exists, and (iv) collection of the receivable is reasonably assured. These terms are typically met upon shipment of product to the customer, except for certain distributors who have a contractual right of return. Revenue with respect to these distributors is deferred until the purchased products are sold through by the distributor to a third party. Other distributors have limited stock rotation rights, which allow them to rotate up to 10% of product in their inventory two times a year. We recognize revenue to these distributors upon shipment of product to the distributor, as the stock rotation rights are limited and we believe that we have the ability to estimate and establish allowances for expected product returns in accordance with SFAS No. 48, Revenue Recognition When Right of Return Exists. Development revenue is recognized when services are performed and was not significant for any of the periods presented.

Our net revenues for the third fiscal quarter of 2005 were \$197.5 million or an increase of 16% over second fiscal quarter 2005 revenues of \$169.7 million and a 26% decrease from third fiscal quarter 2004 net revenues of \$267.6 million.

During fiscal 2004, we experienced lower than expected end customer demand which resulted in excess channel inventory build up at our direct customers, distributors and resellers. During the six months ended March 31, 2005, there was an approximate \$70.0 million reduction in channel inventories at our distributors and direct customers, of which \$20.0 million occurred in the quarter ended March 31, 2005. The net revenue increase in the quarter ended June 30, 2005 as compared to the quarter ended March 31, 2005 is primarily attributable to a 20% increase in end customer demand based on units sold, including the \$20.0 million channel inventory reduction in the prior quarter, offset by price erosion of less than 5%.

The 26% decrease in net revenues from the quarter ended June 30, 2004 to the quarter ended June 30, 2005, and the 26% decrease in net revenues for the nine months ended June 30, 2004 to the nine months ended June 30, 2005 is primarily due to average selling price erosion.



**Table of Contents****Gross Margin**

(in millions)	Three months ended			Change from March 2005 Quarter	Change from June 2004 Quarter
	June 30, 2005	31, 2005	June 30, 2004		
Gross margin	\$75.0	\$60.0	\$112.5	25%	(33)%
Percent of net revenues	38%	35%	42%		

(in millions)	Nine months ended		Change
	June 30, 2005	June 30, 2004	
Gross margin	\$142.2	\$293.3	(52)%
Percent of net revenues	28%	43%	

Gross margin represents net revenues less cost of goods sold. As a fabless semiconductor company, we use third parties for wafer production, assembly and test services. Our cost of goods sold consists predominantly of purchased finished wafers, assembly and test services, royalty and other intellectual property costs and labor and overhead associated with product procurement.

Our gross margin for the third fiscal quarter of 2005 was 38% compared with the 35% for the second fiscal quarter of 2005 and 42% for the similar period of fiscal 2004. The conclusion of the channel inventory reduction in the second quarter of fiscal 2005 required \$9.6 million in out of the ordinary channel inventory pricing actions which decreased our gross margin in the second fiscal quarter to 35% and subsequently resulted in an increase on a sequential basis. This increase was partially offset by the impact of additional inventory reserves of \$2.1 million, net of a benefit of \$1.3 million for the sale of previously reserved inventory products. The decrease as compared to the third fiscal quarter of 2004 is attributable to the 26% decrease in average selling prices and partially offset by lower inventory costs.

Our gross margin for the first nine months of fiscal 2005 was 28% compared with the similar period of fiscal 2004 gross margin of 43%. The gross margin percentage decrease from the first nine months of fiscal 2004 is attributable to the effects of (i) net inventory charges of \$42.5 million, (ii) the re-establishment of \$17.5 million of revenue reserves, which are maintained by the Company to estimate customer pricing adjustments, and were depleted as a result of special pricing given to select customers to facilitate the reduction of channel inventory during the first six months of fiscal 2005, and (iii) the 26% decrease in average selling prices which were partially offset by lower inventory costs. We expect that our gross margin percentage will increase in future periods in relation to our gross margin percentage for the quarter ended June 30, 2005 as a result of product cost reduction programs and product mix.

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We assess the recoverability of our inventories at least quarterly through a review of inventory levels in relation to foreseeable demand, generally over nine to twelve months. Foreseeable demand is based upon all available information, including sales backlog and forecasts, product marketing plans and product life cycle information. When the inventory on hand exceeds the foreseeable demand, we write down the value of those inventories which, at the time of our review, we expect to be unable to sell. The amount of the inventory write-down is the excess of historical cost over estimated realizable value. Once established, these write-downs are considered permanent adjustments to the cost basis of the excess inventory. Demand for our products may fluctuate significantly over time, and actual demand and market conditions may be more or less favorable than those projected by management. In the event that actual demand is lower than originally projected, additional inventory write-downs may be required. Similarly, in the event that actual demand exceeds original projections, gross margins may be favorably impacted in future periods. During the nine months ended June 30, 2005, we recorded \$31.3 million in inventory charges for excess and obsolete (E&O) inventory primarily as a result of the reduced demand outlook for fiscal year 2005 related to Broadband Access and Wireless Networking products. Activity in our E&O inventory reserves for the three and nine months ended June 30, 2005 was as follows:

	<b>Three months ended June 30, 2005</b>	<b>Nine months ended June 30, 2005</b>
E&O reserves, beginning of period	\$ 53,302	\$ 23,319
Additions	2,131	31,296
Release upon sales of product	(1,298)	(2,299)
Scrap	(3,460)	(5,502)
Standards adjustments and other	(864)	2,997
E&O reserves, end of period	\$ 49,811	\$ 49,811

We have created an action plan at a product line level to scrap approximately 30% of the E&O products and we are still in the process of evaluating the remaining reserved products. It is possible that some of these reserved products will be sold which will benefit our gross margin in the period sold. During the three and nine months ended June 30, 2005, we sold \$1.3 million and \$2.3 million, respectively, of reserved products which benefited our gross margin in the associated period.

Our products are used by communications electronics OEMs that have designed our products into communications equipment. For many of our products, we gain these design wins through a lengthy sales cycle, which often includes providing technical support to the OEM customer. Moreover, once a customer has designed a particular supplier's components into a product, substituting another supplier's components often requires substantial design changes which involve significant cost, time, effort and risk. In the event of the loss of business from existing OEM customers, we may be unable to secure new customers for our existing products without first achieving new design wins. When the quantities of inventory on hand exceed foreseeable demand from existing OEM customers into whose products our products have been designed, we generally will be unable to sell our excess inventories to others, and the estimated realizable value of such inventories to us is generally zero.

Further, on a quarterly basis, we assess the net realizable value of our inventories. When the estimated average selling price, plus costs to sell our inventory falls below our inventory cost, we adjust our inventory to its current estimated market value. During the nine months ended June 30, 2005, we recorded \$18.9 million in inventory charges to adjust certain Wireless Networking products to their estimated market value. Increases to this inventory reserve may be required based upon actual average selling prices and changes to our current estimates, which would impact our gross margin percentage in future periods. Activity in our lower of cost or market (LCM) inventory reserves for the three and nine months ended June 30, 2005 was as follows:

	<b>Three months ended June 30, 2005</b>	<b>Nine months ended June 30, 2005</b>
LCM reserves, beginning of period	\$ 11,093	\$
Additions		18,854
Release upon sales of product	(1,488)	(5,370)
Scrap		
Standards adjustments and other	(2,588)	(6,467)
LCM reserves, end of period	\$ 7,017	\$ 7,017

**Table of Contents****Research and Development**

	<b>Three months ended</b>			<b>Change</b>	<b>Change</b>
	<b>March</b>			<b>from</b>	<b>from</b>
<b>(in millions)</b>	<b>June 30,</b>	<b>31,</b>	<b>June 30,</b>	<b>March</b>	<b>June 2004</b>
	<b>2005</b>	<b>2005</b>	<b>2004</b>	<b>2005</b>	<b>Quarter</b>
Research and development	\$66.3	\$70.5	\$74.3	(6)%	(11)%
Percent of net revenues	34%	42%	28%		

	<b>Nine months ended</b>			<b>Change</b>
<b>(in millions)</b>	<b>June 30,</b>	<b>June 30,</b>		
	<b>2005</b>	<b>2004</b>		
Research and development	\$209.4	\$167.2		25%
Percent of net revenues	41%	24%		

Our research and development (R&D) expenses consist principally of direct personnel costs to develop new communications and semiconductor products, allocated direct costs of the R&D function, photo mask and other costs for pre-production evaluation and testing of new devices and design and test tool costs. Our R&D expenses also include the costs for design automation and advanced package development, and non-cash stock compensation charges related to the amortization of unvested stock options exchanged in the Merger and other acquisitions. The \$8.0 million decrease in R&D expenses for the third quarter of fiscal 2005 compared to the similar period of fiscal 2004 primarily reflects the impact of our restructuring efforts which shifted resources to lower cost regions. As a result of cost reduction initiatives, we expect that quarterly R&D expenses will be lower in future periods, except for the impact of stock option expense charges under SFAS No. 123 (R) commencing in the first fiscal quarter of 2006. The \$42.2 million increase in R&D expenses for the nine months ended June 30, 2005 compared to the similar period of fiscal 2004 primarily reflects additional development costs associated with DSL and Wireless Networking products as a result of the Merger (9 months in the 2005 period and only 4 months in comparable 2004 period), and an increase of \$3.6 million in stock compensation charges primarily as a result of the Merger, partially offset by the recent favorable impact of our shifting of resources to lower cost regions. As a result of cost reduction initiatives, we expect that quarterly R&D expenses will be lower in future periods, except for the impact of stock option expense charges under SFAS No. 123 (R) commencing in the first fiscal quarter of 2006. When compared to the immediately preceding quarter, R&D expenses for the quarter ended June 30, 2005 decreased \$4.2 million. This decrease is reflective of our cost reduction initiatives.

**Table of Contents****Selling, General and Administrative**

	<b>Three months ended</b>			<b>Change</b>	<b>Change</b>
	<b>March</b>			<b>from</b>	<b>from</b>
<b>(in millions)</b>	<b>June 30,</b>	<b>31,</b>	<b>June 30,</b>	<b>March</b>	<b>June 2004</b>
	<b>2005</b>	<b>2005</b>	<b>2004</b>	<b>2005</b>	<b>Quarter</b>
Selling, general and administrative	\$31.1	\$28.4	\$36.4	10%	(15)%
Percent of net revenues	16%	17%	14%		

	<b>Nine months ended</b>			<b>Change</b>
<b>(in millions)</b>	<b>June 30,</b>	<b>June 30,</b>		
	<b>2005</b>	<b>2004</b>		
Selling, general and administrative	\$89.4	\$89.8		nm
Percent of net revenues	18%	13%		

nm = not  
meaningful

Our selling, general and administrative (SG&A) expenses include personnel costs, sales representative commissions, advertising and other marketing costs. Our SG&A expenses also include costs of corporate functions including legal, accounting, treasury, human resources, customer service, sales, marketing, field application engineering, allocated indirect costs of the SG&A function, and other services, and non-cash stock compensation charges related to the amortization of unvested stock options exchanged in the Merger and other acquisitions.

The \$5.3 million decrease in SG&A expenses for the quarter ended June 30, 2005 compared to the same period of fiscal 2004 is attributable to a \$0.4 million reduction in our accounts receivable bad debt allowance which was based on improved collections experience, and the realization of a portion of our cost reduction initiatives.

SG&A expenses for the nine months ended June 30, 2005 compared to the similar period of fiscal 2004 stayed approximately flat and was the result of a \$1.0 million increase in legal expenses, a \$1.2 million increase in stock compensation charges as a result of the Merger, and additional SG&A costs as a result of the Merger (9 months in the 2005 period and only 4 months in comparable 2004 period), partially offset by the second quarter's \$1.3 million refund of previously expensed and remitted sales taxes and a \$1.5 million reduction in accounts receivable bad debt allowance which was based on improved collections experience.

When compared to the immediately preceding quarter, SG&A expenses for the quarter ended June 30, 2005 increased \$2.7 million. This increase is primarily a result of the second quarter's refund of \$1.3 million in previously remitted sales taxes and approximately \$1.4 million in higher legal expenses. As a result of our cost reduction initiatives, we expect that quarterly SG&A expenses will be lower in future periods, except for the impact of stock option expense charges under SFAS No. 123 (R) commencing in the first fiscal quarter of 2006.

**Amortization of Intangible Assets**

	<b>Three months ended June 30,</b>		
<b>(in millions)</b>	<b>2005</b>	<b>Change</b>	<b>2004</b>
Amortization of intangible assets	\$8.0		\$8.0
Percent of net revenues	nm		nm

	<b>Nine months ended June 30,</b>		
<b>(in millions)</b>	<b>2005</b>	<b>Change</b>	<b>2004</b>
Amortization of intangible assets	\$24.4	nm	\$12.6
Percent of net revenues	nm		nm

nm = not  
meaningful

Amortization expense is recorded for intangible assets other than goodwill pursuant to SFAS Nos. 141 and 142. SFAS No. 141 requires that all business combinations be accounted for using the purchase method and provides

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criteria for recording intangible assets separately from goodwill. Goodwill must be tested at least annually for impairment and written down when impaired.

The increased amortization expense in the nine months ended June 30, 2005 compared to the nine months ended June 30, 2004 is primarily attributable to the significant intangible assets we acquired in the Merger. See Note 2 of Notes to Consolidated Condensed Financial Statements for further information. We expect that amortization of intangible assets will be approximately \$7.9 million for the remainder of fiscal 2005.

**In-Process Research and Development**

(in millions)	Nine months ended June 30,		
	2005	Change	2004
Amortization of intangible assets	\$	nm	\$ 160.8
Percent of net revenues	nm		nm

nm = not meaningful

The in-process research and development (IPR&D) charge of \$160.8 million in the nine months ended June 30, 2004 is related to the Merger completed on February 27, 2004. See Note 2 of Notes to the Consolidated Condensed Financial Statements for a discussion of the IPR&D charge.

**Special Charges**

Special charges consist of the following:

(in millions)	Three months ended June 30,			Nine months ended June 30,		
	2005	Change	2004	2005	Change	2004
Restructuring charges	\$6.7	nm	\$3.6	\$24.5	nm	\$ 4.1
Asset impairment charges	0.1	nm	2.5	3.5	nm	4.5
Integration charges	1.6	nm	1.6	6.8	nm	4.2
Other special charges		nm	0.6	6.5	nm	1.6
	\$8.4		\$8.3	\$41.3		\$14.4

nm = not meaningful

See Note 7 of Notes to Consolidated Condensed Financial Statements for a discussion of asset impairment charges, restructuring charges, integration charges and other special charges.

**Interest Expense**

(in millions)	Three months ended June 30,		
	2005	Change	2004
Interest expense	\$8.4		\$8.4
Percent of net revenues	nm		nm

(in millions)	Nine months ended June 30,		
	2005	Change	2004
Interest expense	\$25.3	nm	\$22.3
Percent of net revenues	nm		nm

nm = not meaningful

Interest expense is primarily related to our convertible subordinated notes. See Note 3 of Notes to Consolidated Condensed Financial Statements for further description of the notes.

As a result of the acquisition of \$130.0 million of the 5.25% convertible subordinated notes of Conexant, Inc. in the Merger, interest expense in the nine months ended June 30, 2005 was higher than in the nine months ended June 30, 2004.



**Table of Contents****Other (Income) Expense, Net**

(in millions)	Three months ended June 30,		
	2005	Change	2004
Other (income) expense, net	\$(15.6)	nm	\$47.9
Percent of net revenues	nm		nm

(in millions)	Nine months ended June 30,		
	2005	Change	2004
Other (income) expense, net	\$(23.4)	nm	\$(1.0)
Percent of net revenues	nm		nm

nm = not meaningful

Other (income) expense, net for the first nine months of fiscal 2005 was primarily comprised of \$4.0 million of investment and interest income on invested cash balances, and \$42.3 million in gains on sales of equity securities, offset by \$8.6 million of loss in our equity method investments and a \$14.8 million decrease in the fair value of the Mindspeed warrant. Due to variations in the fair value of the common stock underlying the Mindspeed warrant, we expect that other (income) expense, net may fluctuate significantly in future periods until this derivative instrument can be liquidated.

Other (income) expense, net for the first nine months of fiscal 2004 was comprised of \$12.8 million of income in our equity method investments (including a \$11.4 million gain in accordance with Staff Accounting Bulletin No. 51 for the realization of an additional investment made by another party in Jazz), gains of sales of investments of \$27.0 million and \$6.7 million of investment and interest income on invested cash balances, offset by a \$38.4 million decrease in the fair value of the Mindspeed warrant, a \$6.3 million decrease in the fair value of the conversion right under the Skyworks 15% convertible senior subordinated notes, impairments of non-marketable equity investments of \$0.6 million, and other expense of \$0.2 million.

In July 2005, we sold the remaining 2.8 million shares of SiRF Technology Holdings, Inc. for cash proceeds of \$50.9 million and realized gains on the sales of these securities of \$49.0 million.

The carrying values of non-marketable investments are at cost, or their estimated fair values, if lower. These investments consist of equity interests in early stage technology companies which we account for under the cost method. We estimate the fair value of these investments based upon available financial and other information, including the then-current and projected business prospects for the subject companies, and when we determine that the decline in the fair value of these investments is other than temporary, they are written down to fair value.

**Provision for Income Taxes**

We recorded income tax expense of \$1.8 million and \$1.4 million for the nine months ended June 30, 2005 and 2004, respectively, primarily reflecting income taxes imposed on our foreign subsidiaries. No federal income tax expense was recorded for the first nine months of fiscal 2005 or 2004 due to our net losses for the period. Except to the extent of the federal alternative minimum tax (AMT), we expect this will continue for the foreseeable future. We do not expect to recognize any income tax benefits relating to future operating losses until we believe that such tax benefits are more likely than not to be realized. Under the AMT system, a current year deduction is somewhat more beneficial than utilization of a net operating loss (NOL). To reduce our future expected AMT, during the quarter ended June 30, 2005, we capitalized R&D expenses of approximately \$581.0 million out of our previously reported \$1.75 billion in NOLs to create future tax deductions. This adjustment was made for tax reporting purposes and had no impact on the accompanying financial statements.

As of June 30, 2005, Conexant had \$1.3 billion of fully reserved deferred tax assets which are available to offset future tax obligations, of which approximately \$440.0 million were acquired in the Merger, and if Conexant receives a tax benefit from their utilization, the benefit will be recorded as a reduction to goodwill. The deferred tax assets

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acquired in the Merger are subject to limitations imposed by section 382 of the Internal Revenue Code. Such limitations are not expected to impair our ability to utilize these deferred tax assets.

In connection with the divestiture of certain businesses in prior years, we retained tax liabilities and the rights to tax refunds for periods prior to the respective divestitures. As a result, from time to time, we may receive refunds or may be required to make payments related to tax matters associated with these divested businesses. Amounts recorded for these matters, if any, are based on estimates. We review and revise these estimates as appropriate to take into account all information we have available. Actual amounts received or paid, if any, could differ materially from those estimates and would accordingly result in an adjustment to results of operations in the period the refunds are received or payments are made.

**Liquidity and Capital Resources**

Our cash and cash equivalents increased by \$21.5 million during the first nine months of fiscal 2005. Cash used by operating activities was \$58.7 million for the first nine months of fiscal 2005, compared to cash provided by operating activities of \$1.7 million for the comparable period in fiscal 2004. Cash flows used in operations for the first nine months of fiscal 2005 were \$105.4 million, before \$100.2 million of net favorable changes in working capital, an \$8.0 million payment to Agere for the settlement of patent litigation, and \$45.5 million of payments related to special charges and other restructuring related items. The favorable working capital changes were driven by (i) improved days sales outstanding primarily the result of increased cash collections, from 79 days in the September 2004 quarter to 38 days in the June 2005 quarter, and (ii) improved inventory turns from 2.6 turns in the September 2004 quarter to 4.7 turns in the June 2005 quarter.

Cash provided by investing activities of \$79.2 million for the first nine months of fiscal 2005 includes net proceeds of \$49.1 million received from the purchase and sale-leaseback of our headquarters facility and other assets, proceeds from the sale of equity securities, primarily in SiRF Technology Holdings, Inc., of \$44.4 million, and net sales of other marketable securities of \$23.6 million. These cash flows from investing activities of approximately \$117.0 million were offset by cash used in investing activities for acquisitions of \$18.8 million, capital expenditures of \$16.4 million, and investments of \$2.6 million. Cash used in investing activities of \$23.4 million in the first nine months of fiscal 2004 principally consisted of \$29.4 million of net purchases of marketable securities, capital expenditures of \$13.9 million, payment of deferred purchase consideration of \$4.0 million, payment of acquisition costs of \$29.8 million, and investments of \$2.6 million, partially offset by \$24.8 million of net cash and cash equivalents acquired in acquisitions (primarily in the Merger). In July 2005, we sold the remaining 2.8 million shares of SiRF Technology Holdings, Inc. for cash proceeds of \$50.9 million.

Cash provided by financing activities of \$1.0 million for the first nine months of fiscal 2005 consisted of \$0.8 million in proceeds from the exercise of stock options and \$0.2 million from repayment of an employee loan. The \$24.1 million in cash provided by financing activities for the comparable period of fiscal 2004 consisted of proceeds from the exercise of stock options. The decrease in proceeds from the exercise of stock options reflects the decrease in our stock price in the similar periods. Our stock price at June 30, 2005 and 2004 was \$1.65 and \$4.08, respectively. As of June 30, 2005, our principal sources of liquidity are our existing cash reserves and marketable securities, our investments in third parties, such as Jazz, our Mindspeed warrant and cash generated from product sales. Given current market conditions relating to the Mindspeed warrant, we determined that at this time, we do not have the ability to liquidate a portion of the warrant in the next twelve months. Consequently, all amounts related to the value of the Mindspeed warrant are reflected as long-term on our condensed consolidated balance sheet. Our working capital at June 30, 2005 was \$106.1 million compared to \$434.8 million at September 30, 2004. The decrease is attributable to the reclassification of \$196.8 million of our convertible subordinated notes which are due in May 2006 to current liabilities, and our loss from operations. In addition, at June 30, 2005 we held \$72.0 million in long-term marketable securities which we could liquidate to fund operations and/or future acquisitions.

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Total cash, cash equivalents and marketable securities are as follows:

(in millions)	June 30, 2005	September 30, 2004
Cash and cash equivalents	\$ 160.5	\$ 139.0
Other short-term marketable securities (primarily mutual funds, domestic government agencies and corporate debt securities)	58.1	13.8
Long-term marketable securities (primarily domestic government agencies and corporate debt securities)	72.0	137.6
Subtotal	290.6	290.4
Equity securities- Skyworks Solutions, Inc. (6.2 million shares at June 30, 2005 and September 30, 2004)	46.2	61.8
Equity securities- SiRF Technology Holdings, Inc. (2.8 million shares at June 30, 2005 and 5.9 million shares at September 30, 2004)	49.0	87.5
Subtotal Skyworks and SiRF	95.2	149.3
Total cash, cash equivalents and marketable securities	\$385.8	\$ 439.7

The fair value of the Mindspeed warrant at June 30, 2005 is \$11.2 million. The valuation of this derivative instrument is subjective, and at any point in time could ultimately result in the realization of amounts significantly different than the carrying value. Further, there is no assurance that the equity markets would allow for the Company to liquidate a substantial portion of these warrants within a short time period without significantly impacting the market value. We believe that our existing sources of liquidity will be sufficient to fund our operations, research and development efforts, anticipated capital expenditures, and other liabilities and commitments, and other capital requirements, for at least the next twelve months. We will need to continue a focused program of capital expenditures to meet our research and development and corporate requirements. We may also consider additional acquisition opportunities to extend our technology portfolio and design expertise and to expand our product offerings. In order to fund capital expenditures, increase our working capital or complete any acquisitions, we may seek to obtain additional debt financing or issue additional shares of our common stock. However, we cannot assure you that such financing will be available to us on favorable terms, or at all.

We have \$711.8 million aggregate principal amount of convertible subordinated notes outstanding, of which \$196.8 million is current and is due in May 2006 and the remainder becomes due in February 2007. The conversion prices of the notes are currently substantially in excess of the market value of our common stock. As of June 30, 2005, we had \$385.8 million of cash and investments. We believe that we will repay the \$196.8 million of the notes coming due in May 2006 with existing cash resources, marketable securities and cash generated from operations and our investments and other assets. If we are unable to generate sufficient cash flows from our operations or realize additional value from our investments and other assets, we may have to seek additional sources of financing to satisfy the amounts coming due in February 2007. We cannot assure you that such financing will be available to us on favorable terms, or at all.

The following summarizes our contractual obligations at June 30, 2005:

Payments due by period	
Less than 1	More than 5

<b>(in millions)</b>	<b>Total</b>	<b>Year</b>	<b>1-3 years</b>	<b>3-5 years</b>	<b>years</b>
Convertible subordinated notes (1)	\$711.8	\$196.8	\$515.0	\$	\$
Operating leases	205.6	30.6	47.1	35.0	92.9
Assigned leases	8.3	0.4	3.4		4.5
Contingent consideration on acquisitions	6.0	6.0			
Capital commitments	5.9	5.9			
Employee commitments	1.3	1.3			
	\$938.9	\$241.0	\$565.5	\$35.0	\$ 97.4

(1) Excludes interest. See Note 3 of Notes to Consolidated Condensed Financial Statements for interest terms.

At June 30, 2005, the Company has many sublease arrangements on operating leases for terms ranging from near term to approximately 6 years. Aggregate scheduled sublease income based on current terms is approximately \$19.7 million.

**Table of Contents****Off-Balance Sheet Arrangements**

Our off-balance arrangements consist of conventional operating leases, capital commitments, employee commitments, and purchase commitments as described in Note 5 of Notes to Consolidated Condensed Financial Statements. We also have contingent liabilities for other items assigned to Mindspeed and Skyworks at the time of their separation from Conexant. See Note 5 of Notes to Consolidated Condensed Financial Statements. We do not have any special purpose entities or variable interest entities as of June 30, 2005.

**Recent Accounting Pronouncements**

In December 2004, the Financial Accounting Standards Board issued SFAS No. 123 (R), *Share-Based Payment*. This pronouncement amends SFAS No. 123, and supersedes APB Opinion No. 25. SFAS No. 123 (R) requires that public companies account for awards of equity instruments issued to employees under the fair value method of accounting and recognize such amounts in the statement of operations. The implementation of this statement was delayed by the Securities and Exchange Commission and will be effective beginning with our first quarter of fiscal 2006. We expect the impact of this new pronouncement to be significant to our results of operations.

**Critical Accounting Policies**

The preparation of financial statements in accordance with accounting principles generally accepted in the United States requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Among the significant estimates affecting our consolidated financial statements are those relating to allowances for doubtful accounts, inventories, long-lived assets, in-process research and development (IPR&D), valuation of and estimated lives of identifiable intangible assets, income taxes, valuation of derivative instruments, restructuring costs, long-term employee benefit plans and other contingencies. We regularly evaluate our estimates and assumptions based upon historical experience and various other factors that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. To the extent actual results differ from those estimates, our future results of operations may be affected.

***Business combinations***

We account for acquired businesses using the purchase method of accounting which requires that the assets and liabilities assumed be recorded at the date of acquisition at their respective fair values. Because of the expertise required to value intangible assets and IPR&D, we typically engage a third party valuation firm to assist management in determining those values. Valuation of intangible assets and IPR&D entails significant estimates and assumptions including, but not limited to: determining the timing and expected costs to complete projects, estimating future cash flows from product sales, and developing appropriate discount rates and probability rates by project. We believe that the fair values assigned to the assets acquired and liabilities assumed are based on reasonable assumptions. To the extent actual results differ from those estimates, our future results of operations may be affected by incurring charges to our statements of operations. Additionally, estimates for purchase price allocations may change as subsequent information becomes available.

***Impairment of long-lived assets***

Long-lived assets, including fixed assets and intangible assets (other than goodwill), are continually monitored and are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of any such asset may not be recoverable. The determination of recoverability is based on an estimate of undiscounted cash flows expected to result from the use of an asset and its eventual disposition. The estimate of cash flows is based upon, among other things, certain assumptions about expected future operating performance, growth rates and other factors. Our estimates of undiscounted cash flows may differ from actual cash flows due to, among other things, technological changes, economic conditions, changes to our business model or changes in our operating performance. If the sum of the undiscounted cash flows (excluding interest) is less than the carrying value, we

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recognize an impairment loss, measured as the amount by which the carrying value exceeds the fair value of the asset. We determine fair value by using available market data, comparable asset quotes and/or discounted cash flow models. Goodwill is tested for impairment annually, or when a possible impairment is indicated, using the fair value based test prescribed by SFAS No. 142. The estimates and assumptions described above (along with other factors such as discount rates) will affect the outcome of our impairment tests and the amounts of any resulting impairment losses.

***Deferred income taxes***

We evaluate the realizability of our deferred tax assets and assess the need for a valuation allowance quarterly. We record a valuation allowance to reduce our deferred tax assets to the net amount that is more likely than not to be realized. Our assessment of the need for a valuation allowance is based upon our history of operating results, expectations of future taxable income and the ongoing prudent and feasible tax planning strategies available to us. In the event that we determine that we will not be able to realize all or part of our deferred tax assets in the future, an adjustment to the deferred tax assets would be charged against income in the period such determination is made. Likewise, in the event we were to determine that we will be able to realize our deferred tax assets in the future in excess of the net recorded amount, an adjustment to the deferred tax assets would increase income in the period such determination is made. To the extent that we realize a benefit from reducing the valuation allowance on acquired deferred tax assets, the benefit will be credited to goodwill.

***Inventories***

We assess the recoverability of our inventories at least quarterly through a review of inventory levels in relation to foreseeable demand, generally over nine to twelve months. Foreseeable demand is based upon all available information, including sales backlog and forecasts, product marketing plans and product life cycle information. When the inventory on hand exceeds the foreseeable demand, we write down the value of those inventories which, at the time of our review, we expect to be unable to sell. The amount of the inventory write-down is the excess of historical cost over estimated realizable value. Once established, these write-downs are considered permanent adjustments to the cost basis of the excess inventory. Demand for our products may fluctuate significantly over time, and actual demand and market conditions may be more or less favorable than those projected by management. In the event that actual demand or product pricing is lower than originally projected, additional inventory write-downs may be required. Further, on a quarterly basis, we assess the net realizable value of our inventories. When the estimated average selling price, plus costs to sell our inventory falls below our inventory cost, we adjust our inventory to its current estimated market value.

***Allowance for doubtful accounts***

We maintain allowances for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. We use a specific identification method for some items, and a percentage of aged receivables for others. The percentages are determined based on our past experience. If the financial condition of our customers were to deteriorate, our actual losses may exceed our estimates, and additional allowances would be required.

***Non-marketable equity securities***

We have a portfolio of strategic investments in non-marketable equity securities. Our ability to recover our investments in private, non-marketable equity securities and to earn a return on these investments is primarily dependent on how successfully these companies are able to execute to their business plans and how well their products are accepted, as well as their ability to obtain venture capital funding to continue operations and to grow. We review all of our investments periodically for impairment and an impairment analysis of non-marketable equity securities requires significant judgment. This analysis includes assessment of each investee's financial condition, the business outlook for its products and technology, its projected results and cash flows, the likelihood of obtaining subsequent rounds of financing and the impact of any relevant contractual equity preferences held by us or by others. Overall business valuations have declined significantly over the past two years, and as a result we have experienced substantial impairments in the value of non-marketable equity securities investments we hold. Future adverse changes in market conditions or poor operating results of underlying investments could result in an inability

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to recover the carrying value of our investments that may not be reflected in their current carrying values, which could require additional impairment charges to write down the carrying values of such investments.

***Revenue recognition***

Revenue is recognized when (i) the risk of loss has been transferred to the customer, (ii) price and terms are fixed, (iii) no significant vendor obligation exists, and (iv) collection of the receivable is reasonably assured. These terms are typically met upon shipment of product to the customer, except for certain distributors who have a contractual right of return. Revenue with respect to these distributors is deferred until the purchased products are sold through by the distributor to a third party. Other distributors have limited stock rotation rights, which allow them to rotate up to 10% of product in their inventory two times a year. We recognize revenue to these distributors upon shipment of product to the distributor, as the stock rotation rights are limited and we believe that we have the ability to estimate and establish allowances for expected product returns in accordance with SFAS No. 48, *Revenue Recognition When Right of Return Exists*. Our revenue recognition policy is significant because our revenue is a key component of our operations and the timing of revenue recognition determines the timing of certain expenses, such as sales commissions. Revenue results are difficult to predict, and any shortfall in revenues could cause our operating results to vary significantly from period to period.

Conexant has more than 20 distributor customers for whom revenue is recognized upon its shipment of product to them, as the contractual terms provide for limited or no rights of return. During the three months ended December 31, 2004, we determined that we were unable to enforce our contractual terms with three distribution customers. As a result, from October 1, 2004, we have deferred the recognition of revenue on sales to these three distributors until the purchased products are sold by the distributors to a third party.

***Valuation of derivative instruments***

We had two primary types of derivatives – our warrant to purchase shares of common stock of Mindspeed and the conversion right of the Skyworks 15% convertible senior subordinated notes. Until its conversion to common stock in May 2004, we determined the fair value of the conversion right of the Skyworks notes using the actual trading price of the underlying shares of Skyworks common stock. We determine the fair value of the current portion of the Mindspeed warrant using current pricing data. The fair value of the long-term portion of the Mindspeed warrant is determined using a standard Black-Scholes pricing model with assumptions consistent with current market conditions and our intent to liquidate the warrant over a specified time period. The Black-Scholes pricing model requires the input of highly subjective assumptions including expected stock price volatility. Changes in these assumptions, or in the underlying valuation model, could cause the fair value of the Mindspeed warrant to vary significantly from period to period.

***Restructuring charges***

We recorded \$24.5 million of restructuring charges in the nine months ended June 30, 2005. These charges relate to reductions in our workforce and related impact on the use of facilities. The estimated charges contain estimates and assumptions made by management about matters which are uncertain at the time, for example the timing and amount of sublease income that will be achieved on vacated property and the operating costs to be paid until lease termination, and the discount rates used in determining the present value (fair value) of remaining minimum lease payments on vacated properties. While we have used our best estimates based on facts and circumstances available at the time, different estimates reasonably could have been used in the relevant periods, and the actual results may be different, and those differences could have a material impact on the presentation of our financial condition or results of operations. Our policies require us to review the estimates and assumptions periodically and reflect the effects of any revisions in the period that they are determined to be necessary. Such amounts also contain estimates and assumptions made by management, and are reviewed periodically and adjusted accordingly.

***Employee benefit plans***

We have long-term liabilities recorded for a retirement medical plan and a pension plan. These obligations and the related effects on operations are determined using actuarial valuations. There are critical assumptions used in these valuation models such as the discount rate, expected return on assets, compensation levels, turnover rates and mortality rates. The discount rate used is representative of a high-quality fixed income investment. The other





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assumptions do not tend to change materially over time. We evaluate all assumptions annually and they are updated to reflect our experience.

***Stock-based compensation***

We account for employee stock-based compensation in accordance with the provisions of Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* (APB 25) and therefore no compensation expense has been recognized for fixed stock option plans as options are granted at fair market value on the date of grant. We also have an employee stock purchase plan for all eligible employees. We have adopted the pro forma disclosure provisions of Statement of Financial Accounting Standards (SFAS) No. 123, *Accounting for Stock-Based Compensation*, as amended by SFAS No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure*. In December 2004, the Financial Accounting Standards Board issued SFAS No. 123 (R), *Share-Based Payment*. This pronouncement amends SFAS No. 123 and supersedes APB 25. SFAS No. 123 (R) requires that public companies account for awards of equity instruments issued to employees under the fair value method of accounting and recognize such amounts in the statement of operations. The implementation of this statement was delayed by the Securities and Exchange Commission and will be effective beginning with our first quarter of fiscal 2006. We expect the impact of this new pronouncement to be significant to our results of operations.

***Certain Business Risks***

Our business, financial condition and operating results can be impacted by a number of factors, any one of which could cause our actual results to vary materially from recent results or from our anticipated future results. Any of these risks could materially and adversely affect our business, financial condition and results of operations, which in turn could materially and adversely affect the price of our common stock or other securities.

Unless the context otherwise indicates, as used in this section, the terms *Conexant* and *GlobespanVirata* refer to the separate businesses of Conexant Systems, Inc. and GlobespanVirata, Inc., respectively, as they were conducted for periods prior to the completion of the merger of Conexant and GlobespanVirata on February 27, 2004. References to *we*, *us*, *our*, *the combined company* and other similar terms refer to the combined Conexant and GlobespanVirata business from and after the completion of the merger.

References in this section to *Conexant's* fiscal year refer to the fiscal year ending on the Friday nearest September 30 of each year and references to *GlobespanVirata's* fiscal year refer to the fiscal year ending December 31 of each year.

***We have recently incurred substantial losses and we anticipate additional future losses.***

Our net revenues for the first nine months of fiscal 2005 and for fiscal 2004 were \$507.8 million and \$688.7 million, respectively. Our net loss for the first nine months of fiscal 2005 and for fiscal 2004 was \$226.1 million and \$174.2 million, respectively.

We have implemented a number of expense reduction and restructuring initiatives since late fiscal 2001 to improve our operating cost structure. The cost reduction initiatives included workforce reductions, the closure or consolidation of certain facilities and an increasing shift of product development resources to lower-cost regions, among other actions. However, these expense reduction initiatives alone will not return us to profitability. We expect that reduced end-customer demand as compared to the prior year, price erosion, changes in our revenue mix and other factors will continue to adversely affect our operating results in the near term. In order to return to profitability, we must achieve substantial revenue growth and currently we continue to face an environment of uncertain demand in many of the markets our products address. We cannot assure you as to whether or when we will return to profitability or whether we will be able to sustain such profitability, if achieved.

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***We face a risk that capital needed for our business and to repay our convertible notes will not be available when we need it.***

We believe that our existing sources of liquidity together with cash expected to be generated from product sales will be sufficient to fund our operations, research and development, anticipated capital expenditures, working capital and other financing requirements for at least the next twelve months. However, we cannot assure you that this will be the case and we may need to obtain alternate sources of financing in the future. At June 30, 2005, we have \$711.8 million aggregate principal amount of convertible subordinated notes outstanding, of which \$196.8 million is due in May 2006 and \$515.0 million is due in February 2007. The conversion prices of the notes are currently in excess of the market value of our common stock. If we are unable to generate sufficient cash flows from our operations or realize additional value from our investments and other assets, we may be unable to meet our debt obligations as they become due. We cannot assure you that we will have access to additional sources of capital, or be able to refinance our debt, on favorable terms or at all. In periods of a depressed stock price, raising capital through the equity markets would have a greater effect on shareholder dilution.

We hold as marketable securities available for sale a significant amount of equity securities in publicly traded companies. For most of our equity security holdings, there are risks associated with the overall state of the stock market, having available buyers for the shares we sell, and ultimately being able to liquidate the securities at a favorable price. We cannot assure you that the carrying value of these assets will ultimately be realized.

In addition, any strategic investments and acquisitions that we may desire to make to help us grow our business may require additional capital resources. We cannot assure you that the capital required to fund these investments and acquisitions will be available in the future.

***We operate in the highly cyclical semiconductor industry, which is subject to significant downturns.***

The semiconductor industry is highly cyclical and is characterized by constant and rapid technological change, rapid product obsolescence and price erosion, evolving technical standards, short product life cycles and wide fluctuations in product supply and demand. From time to time these and other factors, together with changes in general economic conditions, cause significant upturns and downturns in the industry, and in our business in particular. Periods of industry downturns have been characterized by diminished product demand, production overcapacity, high inventory levels and accelerated erosion of average selling prices. These factors have caused substantial fluctuations in our revenues and results of operations and those of Conexant and GlobespanVirata. Conexant and GlobespanVirata experienced these cyclical fluctuations in their businesses in the past and we have experienced, and may in the future experience, cyclical fluctuations.

Demand for our products in each of the communications electronics end-markets which we address is subject to a unique set of factors, and a downturn in demand affecting one market may be more pronounced, or last longer, than a downturn affecting another of our markets.

***Our operating results may be negatively affected by substantial quarterly and annual fluctuations and market downturns.***

The revenues, earnings and other operating results of Conexant and GlobespanVirata fluctuated in the past and our revenues, earnings and other operating results may fluctuate in the future. These fluctuations are due to a number of factors, many of which are beyond our control. These factors include, among others:

changes in end-user demand for the products manufactured and sold by our customers;

the timing of receipt, reduction or cancellation of significant orders by customers;

seasonal customer demand;

the gain or loss of significant customers;

market acceptance of our products and our customers' products;

our ability to develop, introduce and market new products and technologies on a timely basis;



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the timing and extent of product development costs;

new product and technology introductions by competitors;

changes in the mix of products we develop and sell;

fluctuations in manufacturing yields;

availability and cost of products from our suppliers;

intellectual property disputes; and

the effects of competitive pricing pressures, including decreases in average selling prices of our products. The foregoing factors are difficult to forecast, and these as well as other factors could materially adversely affect our quarterly or annual operating results.

***We are subject to intense competition.***

The communications semiconductor industry in general and the markets in which we compete in particular are intensely competitive. We compete worldwide with a number of United States and international semiconductor providers that are both larger and smaller than us in terms of resources and market share. We currently face significant competition in our markets and expect that intense price and product competition will continue. This competition has resulted in and is expected to continue to result in declining average selling prices for our products. We also anticipate that additional competitors will enter our markets as a result of expected growth opportunities in communications electronics, the trend toward global expansion by foreign and domestic competitors, technological and public policy changes and relatively low barriers to entry in certain markets of the industry. Moreover, as with many companies in the semiconductor industry, customers for certain of our products offer other products that compete with similar products offered by us. Many of our competitors have certain advantages over us, such as significantly greater sales and marketing, manufacturing, distribution, technical and other resources.

We believe that the principal competitive factors for semiconductor suppliers in our addressed markets are:

time-to-market;

product quality, reliability and performance;

level of integration;

price and total system cost;

compliance with industry standards;

design and engineering capabilities;

strategic relationships with customers;

customer support;

new product innovation; and

access to manufacturing capacity.

We cannot assure you that we will be able to successfully address these factors.

Current and potential competitors also have established or may establish financial or strategic relationships among themselves or with our existing or potential customers, resellers or other third parties. These relationships may affect customers' purchasing decisions. Accordingly, it is possible that new competitors or alliances could emerge and rapidly acquire significant market share. We cannot assure you that we will be able to compete successfully against current and potential competitors.

***We may have difficulty integrating businesses we acquire. In particular, we may be unable to integrate successfully the operations of Conexant and GlobespanVirata and realize the full cost savings we anticipated.***

Integrating acquired organizations and their products and services may be expensive, time-consuming and a strain on our resources and our relationships with employees and customers, and ultimately may not be successful.

The merger of Conexant and GlobespanVirata involves the integration of two companies that previously operated independently. The difficulties of combining the operations of the companies include:

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the challenge of effecting integration while carrying on an ongoing business;

the necessity of coordinating geographically separate organizations;

retaining and integrating personnel with diverse business backgrounds;

the challenge of realizing expected operating efficiencies of combining two companies;

retaining existing customers and strategic partners of each company; and

implementing and maintaining consistent standards, controls, procedures, policies and information systems. The process of integrating operations could cause an interruption of, or loss of momentum in, the activities of one or more of our product lines and the loss of key personnel. The diversion of management's attention and any delays or difficulties encountered in connection with the merger and the integration of the two operations could have an adverse effect on our business, results of operations or financial condition. We cannot assure you that the economies of scale and operating efficiencies that we expected to result from the merger will be realized within the time periods contemplated or at all.

***Our success depends, in part, on our ability to effect suitable investments, alliances and acquisitions.***

Although we invest significant resources in research and development activities, the complexity and rapidity of technological changes make it impractical for us to pursue development of all technological solutions on our own. On an ongoing basis, we review investment, alliance and acquisition prospects that would complement our existing product offerings, augment our market coverage or enhance our technological capabilities. However, we cannot assure you that we will be able to identify and consummate suitable investment, alliance or acquisition transactions in the future.

Moreover, if we consummate such transactions, they could result in:

issuances of equity securities dilutive to our existing shareholders;

large initial one-time write-offs of in-process research and development;

the incurrence of substantial debt and assumption of unknown liabilities;

the potential loss of key employees from the acquired company;

amortization expenses related to intangible assets; and

the diversion of management's attention from other business concerns.

Additionally, in periods subsequent to an acquisition, at least on an annual basis or when indicators of impairment exist, we must evaluate goodwill and acquisition-related intangible assets for impairment. When such assets are found to be impaired, they will be written down to estimated fair value, with a charge against earnings. At June 30, 2005, we have \$718.3 million of goodwill, of which \$626.1 million was generated in the Merger. When market capitalization is below book value, it is an indicator that goodwill may be impaired. Our market capitalization has been below book value in the past but was above our book value at June 30, 2005. We performed our annual evaluation of goodwill at June 30, 2005 and determined that as of that date, no impairment was required. However, if our market capitalization drops below our book value for a prolonged period of time, or our current assumptions regarding our future operating performance changes, we may be required to write down the value of our goodwill by taking a non-cash charge against earnings.

***The value of our common stock may be adversely affected by market volatility.***

The trading price of our common stock fluctuates significantly and may be influenced by many factors, including: our operating and financial performance and prospects;

the depth and liquidity of the market for our common stock;

investor perception of us and the industry and markets in which we operate;

our inclusion in, or removal from, any equity market indices;

the level of research coverage of our common stock;

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changes in earnings estimates or buy/sell recommendations by analysts; and

general financial, domestic, international, economic and other market conditions.

In addition, public stock markets have experienced, and are currently experiencing, extreme price and trading volume volatility, particularly in the technology sectors of the market. This volatility has significantly affected the market prices of securities of many technology companies for reasons frequently unrelated to or disproportionately impacted by the operating performance of these companies. These broad market fluctuations may adversely affect the market price of our common stock.

***Our success depends on our ability to timely develop competitive new products and reduce costs.***

Our operating results will depend largely on our ability to continue to introduce new and enhanced semiconductor products on a timely basis. Successful product development and introduction depends on numerous factors, including, among others:

our ability to anticipate customer and market requirements and changes in technology and industry standards;

our ability to accurately define new products;

our ability to timely complete development of new products and bring our products to market on a timely basis;

our ability to differentiate our products from offerings of our competitors;

overall market acceptance of our products;

our ability to invest in significant amounts of research and development; and

our ability to transition product development efforts between and among sites, particularly into India, as we complete our restructuring actions.

As a result of the Paxonet Communications acquisition in December 2004 and organic growth, we have more than tripled our headcount in India to approximately 540 engineers at several design centers since the end of fiscal 2004.

We plan to continue this growth trend in India. Expansion and transition of product development efforts to India entails risks associated with our ability to manage the development of products at remote geographic locations, to achieve key program milestones, and to attract and retain qualified management, technical and other personnel necessary for the design and development of our products. If we experience product design or development delays as a result of the transition, or an inability to adequately staff the programs, there could be a material adverse effect on our results of operations.

We cannot assure you that we will have sufficient resources to make the substantial investment in research and development in order to develop and bring to market new and enhanced products. Furthermore, we are required to continually evaluate expenditures for planned product development and to choose among alternative technologies based on our expectations of future market growth. We cannot assure you that we will be able to develop and introduce new or enhanced products in a timely and cost-effective manner, that our products will satisfy customer requirements or achieve market acceptance, or that we will be able to anticipate new industry standards and technological changes. We also cannot assure you that we will be able to respond successfully to new product announcements and introductions by competitors.

In addition, prices of established products may decline, sometimes significantly and rapidly, over time. We believe that in order to remain competitive we must continue to reduce the cost of producing and delivering existing products at the same time that we develop and introduce new or enhanced products. We cannot assure you that we will be successful and as a result gross margins may decline in future periods.

***We may not be able to keep abreast of the rapid technological changes in our markets***

The demand for our products can change quickly and in ways we may not anticipate because our markets generally exhibit the following characteristics:



rapid technological developments;

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rapid changes in customer requirements;

frequent new product introductions and enhancements;

short product life cycles with declining prices over the life cycle of the products; and

evolving industry standards.

Our products could become obsolete sooner than anticipated because of a faster than anticipated change in one or more of the technologies related to our products or in market demand for products based on a particular technology, particularly due to the introduction of new technology that represents a substantial advance over current technology. Currently accepted industry standards are also subject to change, which may contribute to the obsolescence of our products.

***We may not be able to attract and retain qualified management, technical and other personnel necessary for the design, development and sale of our products. Our success could be negatively affected if key personnel leave.***

Our future success depends on our ability to attract, retain and motivate qualified personnel, including executive officers and other key management and technical personnel. As the source of our technological and product innovations, our key technical personnel represent a significant asset. The competition for such personnel can be intense in the semiconductor industry. While we have entered into employment agreements with some of our key personnel, we cannot assure you that we will be able to attract and retain qualified management and other personnel necessary for the design, development and sale of our products.

We may have particular difficulty attracting and retaining key personnel during periods of poor operating performance. The loss of the services of one or more of our key personnel, including Dwight W. Decker, our Chairman of the Board and Chief Executive Officer, F. Matthew Rhodes, our President, or certain key design and technical personnel, or our inability to attract, retain and motivate qualified personnel could have a material adverse effect on our ability to operate our business.

***If OEMs of communications electronics products do not design our products into their equipment, we will be unable to sell those products. Moreover, a design win from a customer does not guarantee future sales to that customer.***

Our products are not sold directly to the end-user but are components of other products. As a result, we rely on OEMs of communications electronics products to select our products from among alternative offerings to be designed into their equipment. We may be unable to achieve these design wins. Without design wins from OEMs, we would be unable to sell our products. Once an OEM designs another supplier's semiconductors into one of its product platforms, it will be more difficult for us to achieve future design wins with that OEM's product platform because changing suppliers involves significant cost, time, effort and risk. Achieving a design win with a customer does not ensure that we will receive significant revenues from that customer and we may be unable to convert design wins into actual sales. Even after a design win, the customer is not obligated to purchase our products and can choose at any time to stop using our products if, for example, it or its own products are not commercially successful.

***Because of the lengthy sales cycles of many of our products, we may incur significant expenses before we generate any revenues related to those products.***

Our customers may need six months or longer to test and evaluate our products and an additional six months or more to begin volume production of equipment that incorporates our products. The lengthy period of time required also increases the possibility that a customer may decide to cancel or change product plans, which could reduce or eliminate sales to that customer. As a result of this lengthy sales cycle, we may incur significant research and development, and selling, general and administrative expenses before we generate the related revenues for these products, and we may never generate the anticipated revenues if our customer cancels or changes its product plans.

**Table of Contents*****Uncertainties involving the ordering and shipment of our products could adversely affect our business.***

Our sales are typically made pursuant to individual purchase orders and we generally do not have long-term supply arrangements with our customers. Generally, our customers may cancel orders until 30 days prior to shipment. In addition, we sell a portion of our products through distributors and other resellers, some of whom have a right to return unsold products to us. Sales to distributors and other resellers accounted for approximately 28% and 35% of our net revenues for the first nine months of fiscal 2005 and for fiscal 2004, respectively. Our distributors may offer products of several different suppliers, including products that may be competitive with ours. Accordingly, there is a risk that the distributors may give priority to other supplier products and may not sell our products as quickly as forecasted, which may impact their future order levels. We routinely purchase inventory based on estimates of end-market demand for our customers' products, which is difficult to predict. This difficulty may be compounded when we sell to OEMs indirectly through distributors and other resellers or contract manufacturers, or both, as our forecasts of demand are then based on estimates provided by multiple parties. In addition, our customers may change their inventory practices on short notice for any reason. The cancellation or deferral of product orders, the return of previously sold products or overproduction due to the failure of anticipated orders to materialize could result in our holding excess or obsolete inventory, which could result in write-downs of inventory. For example, the reduced demand outlook for fiscal year 2005 and the further decline of average selling prices for certain of our products resulted in inventory charges aggregating \$50.2 million for the first nine months of fiscal 2005. Inventory charges included \$31.3 million for excess and obsolete inventory primarily related to Broadband Access and Wireless Networking products and \$18.9 million of lower of cost or market write-downs for Wireless Networking inventory.

***We are dependent upon third parties for the manufacture, assembly and test of our products.***

We are entirely dependent upon outside wafer fabrication facilities (known as foundries). Under our fabless business model, our revenue growth is dependent on our ability to obtain sufficient external manufacturing capacity, including wafer production capacity. If the semiconductor industry experiences a shortage of wafer fabrication capacity in the future, we may experience delays in shipments or increased manufacturing costs.

There are significant risks associated with our reliance on third-party foundries, including:

- the lack of assured wafer supply, potential wafer shortages and higher wafer prices;

- limited control over delivery schedules, manufacturing yields, production costs and product quality; and

- the unavailability of, or delays in obtaining, access to key process technologies.

The foundries we use may allocate their limited capacity to fulfill the production requirements of other customers that are larger and better financed than us. If we choose to use a new foundry, it typically takes several months to redesign our products for the process technology and intellectual property cores of the new foundry and to complete the qualification process before we can begin shipping products from the new foundry.

We are also dependent upon third parties for the assembly and test of our products. Our reliance on others to assemble and test our products subjects us to many of the same risks as are described herein with respect to our reliance on outside wafer fabrication facilities.

Wafer fabrication processes are subject to obsolescence, and foundries may discontinue a wafer fabrication process used for certain of our products. In such event, we generally offer our customers a "last time buy" program to satisfy their anticipated requirements for our products. The unanticipated discontinuation of wafer fabrication processes on which we rely may adversely affect our revenues and our customer relationships.

The foundries and other suppliers on whom we rely may experience financial difficulties or suffer disruptions in their operations due to causes beyond our control, including labor strikes, work stoppages, electrical power outages, fire, earthquake, flooding or other natural disasters. Certain of our suppliers' manufacturing facilities are located near major earthquake fault lines in California and the Asia-Pacific region. In the event of a disruption of the operations of one or more of our suppliers, we may not have a second manufacturing source immediately available. Such an event could cause significant delays in shipments until we could shift the products from an affected facility or

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supplier to another facility or supplier. The manufacturing processes we rely on are specialized and are available from a limited number of suppliers. Alternate sources of manufacturing capacity, particularly wafer production capacity, may not be available to us on a timely basis. Even if alternate wafer production capacity is available, we may not be able to obtain it on favorable terms, or at all. Difficulties or delays in securing an adequate supply of our products on favorable terms, or at all, could impair our ability to meet our customers' requirements and have a material adverse effect on our operating results.

In addition, the highly complex and technologically demanding nature of semiconductor manufacturing has caused foundries from time to time to experience lower than anticipated manufacturing yields, particularly in connection with the introduction of new products and the installation and start-up of new process technologies. Lower than anticipated manufacturing yields may affect our ability to fulfill our customers' demands for our products on a timely basis. Moreover, lower than anticipated manufacturing yields may adversely affect our cost of goods sold and our results of operations.

***We are subject to the risks of doing business internationally.***

For the first nine months of fiscal 2005 and for fiscal 2004, approximately 89% and 91%, respectively, of our net revenues were from customers located outside of the United States, primarily in the Asia-Pacific region and Europe. Approximately 90% of Conexant's net revenues for fiscal 2003 and approximately 92% of GlobespanVirata's net revenues for fiscal 2003 were from customers located outside the United States, primarily in the Asia-Pacific region and Europe. In addition, we have design centers, sales offices and suppliers located outside the United States, including significant design centers and a workforce of approximately 540 engineers in India, and assembly and test service providers and foundries located in the Asia-Pacific region. Our international sales and operations are subject to a number of risks inherent in selling and operating abroad. These include, but are not limited to, risks regarding:

- currency exchange rate fluctuations;

- local economic and political conditions;

- disruptions of commerce and capital or trading markets due to or related to terrorist activity or armed conflict;

- restrictive governmental actions, such as restrictions on the transfer or repatriation of funds and trade protection measures, including export duties and quotas and customs duties and tariffs;

- changes in legal or regulatory requirements;

- difficulty in obtaining distribution and support;

- the laws and policies of the United States and other countries affecting trade, foreign investment and loans, and import or export licensing requirements;

- tax laws, including the cost of services provided and products sold between Conexant and its subsidiaries which are subject to review by taxing authorities ; and

- limitations on our ability under local laws to protect our intellectual property.

Because most of our international sales are currently denominated in U.S. dollars, our products could become less competitive in international markets if the value of the U.S. dollar increases relative to foreign currencies. We cannot assure you that the factors described above will not have a material adverse effect on our ability to increase or maintain our foreign sales.

From time to time, we may enter into foreign currency forward exchange contracts to minimize risk of loss from currency exchange rate fluctuations for foreign currency commitments entered into in the ordinary course of business. We have not entered into foreign currency forward exchange contracts for other purposes. Our financial condition and results of operations could be affected (adversely or favorably) by currency fluctuations.

We also conduct a significant portion of our international sales through distributors. Sales to distributors and other resellers accounted for approximately 28% and 35% of our net revenues for the first nine months of fiscal 2005 and fiscal 2004, respectively. Our arrangements with these distributors are terminable at any time, and therefore the loss of these arrangements could have an adverse effect on our operating results. For those international distributors that we account for under a deferred revenue recognition model, we rely on the distributor to provide us timely and accurate product sell through information. No assurances can be given that these international distributors will continue to provide us this information. If we are unable to obtain this information on a timely basis, or if we

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determine that the information we do receive is unreliable, it may affect the accuracy of amounts recorded in our consolidated financial statements, and therefore have an adverse effect on our operating results.

***We may be subject to claims of infringement of third-party intellectual property rights or demands that we license third-party technology, which could result in significant expense and loss of our ability to use, make, sell, export or import our products or one or more components comprising our products.***

The semiconductor industry is characterized by vigorous protection and pursuit of intellectual property rights. From time to time, third parties have asserted and may in the future assert patent, copyright, trademark and other intellectual property rights to technologies that are important to our business and have demanded and may in the future demand that we license their patents and technology. Any litigation to determine the validity of claims that our products infringe or may infringe these rights, including claims arising through our contractual indemnification of our customers, regardless of their merit or resolution, could be costly and divert the efforts and attention of our management and technical personnel. We cannot assure you that we would prevail in litigation given the complex technical issues and inherent uncertainties in intellectual property litigation. If litigation results in an adverse ruling we could be required to:

pay substantial damages;

cease the manufacture, use or sale of infringing products;

discontinue the use of infringing technology;

expend significant resources to develop non-infringing technology; or

license technology from the third party claiming infringement, which license may not be available on commercially reasonable terms, or at all.

***If we are not successful in protecting our intellectual property rights, it may harm our ability to compete.***

We rely primarily on patent, copyright, trademark and trade secret laws, as well as nondisclosure and confidentiality agreements and other methods, to protect our proprietary technologies and processes. At times we incorporate the intellectual property of our customers into our designs, and we have obligations with respect to the non-use and non-disclosure of their intellectual property. In the past, Conexant and GlobespanVirata have engaged in litigation to enforce their intellectual property rights, to protect their trade secrets or to determine the validity and scope of proprietary rights of others, including their customers. We may engage in future litigation on similar grounds, which may require us to expend significant resources and to divert the efforts and attention of our management from our business operations. We cannot assure you that:

the steps we take to prevent misappropriation or infringement of our intellectual property or the intellectual property of our customers will be successful;

any existing or future patents will not be challenged, invalidated or circumvented; or

any of the measures described above would provide meaningful protection.

Despite these precautions, it may be possible for a third party to copy or otherwise obtain and use our technology without authorization, develop similar technology independently or design around our patents. If any of our patents fails to protect our technology it would make it easier for our competitors to offer similar products. In addition, effective patent, copyright, trademark and trade secret protection may be unavailable or limited in certain countries.

***Uncertainties involving litigation could adversely affect our business.***

We and certain of our current and former officers and directors have been sued in several purported securities class action lawsuits, which have now been consolidated into a single action. We and certain of our directors and officers have also been sued in purported shareholder derivative actions. Although we believe that these lawsuits are without merit, an adverse determination could have an impact on the price of our stock. Moreover, regardless of the ultimate result, the lawsuits may divert management's attention and resources from other matters, which could also adversely

affect our business and results of operations.

**Table of Contents*****We may be liable for penalties under environmental laws, rules and regulations, which could adversely impact our business.***

Conexant's former manufacturing operations used a variety of chemicals and were subject to a wide range of environmental protection regulations in the United States and Mexico. We have been designated as a potentially responsible party and are engaged in groundwater remediation at one Superfund site located at a former silicon wafer manufacturing facility and steel fabrication plant in Parker Ford, Pennsylvania formerly occupied by Conexant. In addition, we are engaged in remediations of groundwater contamination at Conexant's former Newport Beach, California wafer fabrication facility. We currently estimate the remaining costs for these remediations to be approximately \$2.9 million and have accrued for these costs as of June 30, 2005.

In the United States, environmental regulations often require parties to fund remedial action regardless of fault. Consequently, it is often difficult to estimate the future impact of environmental matters, including potential liabilities. While we have not experienced any material adverse effects on our operations as a result of such regulations, we cannot assure you that the costs that might be required to complete remedial actions, if any, will not have a material adverse effect on our business, financial condition and results of operations.

***We may be limited in the future in the amount of net operating losses that we can use to offset taxable income.***

As of June 30, 2005, we had approximately \$1.2 billion of U.S. federal income tax net operating loss (NOL) carry forwards that can be used to offset taxable income in subsequent years. The NOL carry forwards are scheduled to expire at various dates through 2023. Section 382 of the Internal Revenue Code could limit the future use of some or all of the NOL carry forwards if the ownership of our common stock changes by more than 50 percentage points in certain circumstances over a three-year testing period. Based on information known to us, we have not undergone such a change of ownership and the merger of Conexant and GlobespanVirata did not constitute a change of ownership, although the shares of our common stock issued in the Merger will be taken into account in any change of ownership computations. Direct or indirect transfers of our common stock, when taken together with the shift in ownership resulting from the Merger, could result in a change of ownership that would trigger the section 382 limitation. If such an ownership change occurs, section 382 would limit our use of NOL carry forwards in each subsequent taxable year to an amount equal to a federal long-term tax-exempt rate published by the Internal Revenue Service at the time of the ownership change, multiplied by our fair market value at such time; any unused annual limitation amounts may also be carried forward. The Merger resulted in a change of ownership of GlobespanVirata and the future use of GlobespanVirata's NOL carry forwards are subject to the section 382 limitation (or further limitation in the case of NOL carry forwards already subject to limitation as a result of previous transactions) based on the fair market value of GlobespanVirata at the time of the Merger.

***Provisions in our organizational documents and rights agreement and Delaware law may make it difficult for someone to acquire control of us.***

We have established certain anti-takeover measures that may affect our common stock and convertible notes. Our restated certificate of incorporation, our by-laws, our rights agreement with Mellon Investor Services LLC, as rights agent, dated as of November 30, 1998, as amended, and the Delaware General Corporation Law contain several provisions that would make more difficult an acquisition of control of us in a transaction not approved by our board of directors. Our restated certificate of incorporation and by-laws include provisions such as:

- the division of our board of directors into three classes to be elected on a staggered basis, one class each year;

- the ability of our board of directors to issue shares of our preferred stock in one or more series without further authorization of our shareholders;

- a prohibition on shareholder action by written consent;

- a requirement that shareholders provide advance notice of any shareholder nominations of directors or any proposal of new business to be considered at any meeting of shareholders;



a requirement that a supermajority vote be obtained to remove a director for cause or to amend or repeal certain provisions of our restated certificate of incorporation or by-laws;

elimination of the right of shareholders to call a special meeting of shareholders; and

a fair price provision.

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Our rights agreement gives our shareholders certain rights that would substantially increase the cost of acquiring us in a transaction not approved by our board of directors.

In addition to the rights agreement and the provisions in our restated certificate of incorporation and by-laws, Section 203 of the Delaware General Corporation Law generally provides that a corporation shall not engage in any business combination with any interested shareholder during the three-year period following the time that such shareholder becomes an interested shareholder, unless a majority of the directors then in office approves either the business combination or the transaction that results in the shareholder becoming an interested shareholder or specified shareholder approval requirements are met.

***Our internal control over financial reporting may not be considered effective, which could result in a loss of investor confidence in our financial reports and in turn have an adverse effect on our stock price.***

Pursuant to Section 404 of the Sarbanes-Oxley Act of 2002, beginning with our Annual Report on Form 10-K for the fiscal year ending September 30, 2005, we will be required to furnish a report by our management on our internal control over financial reporting. Such report will contain, among other matters, an assessment of the effectiveness of our internal control over financial reporting as of the end of our fiscal year, including a statement as to whether or not our internal control over financial reporting is effective. This assessment must include disclosure of any material weaknesses in our internal control over financial reporting identified by management. The report will also contain a statement that our independent registered public accounting firm has issued an attestation report on management's assessment of internal controls.

We are currently performing the system and process documentation needed to comply with Section 404 and the standards issued by the Public Company Accounting Oversight Board. This process is both costly and challenging. During the performance of this process, if our management identifies one or more material weaknesses in our internal control over financial reporting, we may be unable to assert that such internal control is effective. If we are unable to assert that our internal control is effective as of September 30, 2005 (or if our independent registered public accounting firm is unable to attest that our management's report is fairly stated or they are unable to express an opinion on our management's evaluation or on the effectiveness of our internal controls), investors could lose confidence in the accuracy and completeness of our financial reports, which in turn could have an adverse effect on our stock price.

**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

Our financial instruments include cash and cash equivalents, marketable debt securities, the Mindspeed warrant, equity securities and our long-term debt. Our main investment objectives are the preservation of investment capital and the maximization of after-tax returns on our investment portfolio. Consequently, we invest with only high-credit-quality issuers and we limit the amount of our credit exposure to any one issuer. See also Part I, Item 7A, Quantitative and Qualitative Disclosures About Market Risk in the Company's Annual Report on Form 10-K for the year ended September 30, 2004.

Our cash and cash equivalents, and short-term marketable securities are not subject to significant interest rate risk due to the short maturities of these instruments. As of June 30, 2005, the carrying value of our cash and cash equivalents and short-term marketable securities approximates fair value. Our long-term marketable securities (consisting of commercial paper, corporate bonds and government securities) principally have remaining terms of 1 to 3 years. Such securities are subject to interest rate risk. At June 30, 2005, a 10% adverse change in interest rates would result in a \$7.2 million decrease in the value of our long-term marketable securities.

Marketable equity securities are subject to equity price risk. For most of our equity security holdings, there are risks associated with the overall state of the stock market, having available buyers for shares we sell, and ultimately being able to liquidate the securities at a favorable price. As of June 30, 2005, a 10% adverse change in equity prices would result in a \$9.5 million decrease in the value of our marketable equity securities.

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We classify all of our marketable debt and equity securities as available-for-sale securities. As of June 30, 2005, the carrying value of these securities included net unrealized gains of \$40.2 million.

We hold a warrant to purchase 30 million shares of common stock of Mindspeed. For financial accounting purposes, this is a derivative instrument and the fair value of the warrant is subject to significant risk related to changes in the market price of Mindspeed's common stock. As of June 30, 2005, a 10% decrease in the market price of Mindspeed's common stock would decrease the fair value of this warrant by approximately \$1.7 million. At June 30, 2005, the market price of Mindspeed's common stock was \$1.22 per share. For the quarter ended June 30, 2005, the market price of Mindspeed's common stock ranged from a low of \$1.14 per share to a high of \$2.22 per share.

Our long-term debt consists of convertible subordinated notes with interest at fixed rates. Consequently, we do not have significant cash flow exposure on our long-term debt. However, the fair value of our convertible subordinated notes is subject to significant fluctuation due to their convertibility into shares of our common stock.

The following table shows the fair values of our financial instruments as of June 30, 2005:

(in millions)	<b>Carrying Value</b>	<b>Fair Value</b>
Cash and cash equivalents	\$ 160.5	\$ 160.5
Marketable debt securities	54.3	54.3
Marketable government agency securities	75.8	75.8
Marketable equity securities	95.2	95.2
Mindspeed warrant	11.2	11.2
Current portion of long-term debt	196.8	193.3
Long-term debt	515.0	476.4

We transact business in various foreign currencies, and we have established a foreign currency hedging program utilizing foreign currency forward exchange contracts to hedge certain foreign currency transaction exposures. Under this program, from time to time, we offset foreign currency transaction gains and losses with gains and losses on the forward contracts, so as to mitigate our overall risk of foreign transaction gains and losses. We do not enter into forward contracts for speculative or trading purposes. At June 30, 2005, we held no foreign currency forward exchange contracts. Based on our overall currency rate exposure at June 30, 2005, a 10% change in the currency rates would not have a material effect on our consolidated financial position, results of operations or cash flows.

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**ITEM 4. CONTROLS AND PROCEDURES**

An evaluation as of the end of the period covered by this report was carried out under the supervision and with the participation of the Company's management, including the Company's Chairman and Chief Executive Officer and its Senior Vice President and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures, which are defined under Securities and Exchange Commission rules as controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files under the Securities Exchange Act of 1934 (the Exchange Act) is recorded, processed, summarized and reported within required time periods. Based upon that evaluation, the Company's Chairman and Chief Executive Officer and its Senior Vice President and Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective.

There were no changes in the Company's internal control over financial reporting during the quarter ended June 30, 2005 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

**Table of Contents****PART II. OTHER INFORMATION****ITEM 1. LEGAL PROCEEDINGS**

***IPO Litigation.*** In November 2001, Collegeware Asset Management, LP, on behalf of itself and a putative class of persons who purchased the common stock of GlobeSpan, Inc., (GlobeSpan, Inc. later became GlobespanVirata, Inc., and is now the Company's Conexant, Inc. subsidiary) between June 23, 1999 and December 6, 2000, filed a complaint in the U.S. District Court for the Southern District of New York alleging violations of federal securities laws by the underwriters of GlobeSpan, Inc.'s initial and secondary public offerings as well as by certain GlobeSpan, Inc. officers and directors. The complaint alleges that the defendants violated federal securities laws by issuing and selling GlobeSpan, Inc.'s common stock in the initial and secondary offerings without disclosing to investors that the underwriters had (1) solicited and received undisclosed and excessive commissions or other compensation and (2) entered into agreements requiring certain of their customers to purchase the stock in the aftermarket at escalating prices. The complaint seeks unspecified damages. The complaint was consolidated with class actions against approximately 300 other companies making similar allegations regarding the public offerings of those companies during 1998 through 2000. In June 2003, Conexant, Inc. and the named officers and directors entered into a memorandum of understanding outlining a settlement agreement with the plaintiffs that will, among other things, result in the dismissal with prejudice of all the claims against the former GlobeSpan, Inc. officers and directors. The final settlement was executed in June 2004. On February 15, 2005, the Court issued a decision certifying a class action for settlement purposes and granting preliminary approval of the settlement, subject to modification of certain bar orders contemplated by the settlement. The bar orders have since been modified. The settlement remains subject to a number of conditions and final approval. It is possible that the settlement will not be approved. Even if the settlement is approved, individual class members will have an opportunity to opt out of the class and to file their own lawsuits, and some may do so. In either event, the Company does not anticipate that the ultimate outcome of this litigation will have a material adverse impact on the Company's financial condition, results of operations, or cash flows.

***Class Action Suits.*** In December 2004 and January 2005, the Company and certain current and former officers were named as defendants in several complaints filed on behalf of all persons who purchased Company common stock during a specified class period. These suits were filed in the U.S. District Court of New Jersey (New Jersey cases) and the U.S. District Court for the Central District of California (California cases), alleging that the defendants violated the Securities Exchange Act of 1934 (the Exchange Act) by allegedly disseminating materially false and misleading statements and/or concealing material adverse facts. The California cases have now been consolidated with the New Jersey cases so that all of the class action suits, now known as *Witriol v. Conexant, et al.*, are being heard in the U.S. District Court of New Jersey by the same judge. The defendants believe these charges are without merit and intend to vigorously defend the litigation.

In addition, in February 2005, the Company and certain of its current and former officers and the Company's Employee Benefits Plan Committee were named as defendants in *Graden v. Conexant, et al.*, a lawsuit filed on behalf of all persons who were participants in the Company's 401(k) Plan (the Plan) during a specified class period. This suit was filed in the U.S. District Court of New Jersey and alleges that the defendants breached their fiduciary duties under the Employee Retirement Income Security Act, as amended, to the Plan and the participants in the Plan. The defendants believe these charges are without merit and intend to vigorously defend the litigation.

***Shareholder Derivative Suits.*** In January 2005, the Company and certain current and former directors and officers were named as defendants in purported shareholder derivative actions (now consolidated) in California Superior Court for the County of Orange, alleging that the defendants breached their fiduciary duties, abused control, mismanaged the Company, wasted corporate assets and unjustly enriched themselves. A similar lawsuit was filed in U.S. District Court of New Jersey in May 2005. On July 28, 2005, the court approved a stay of the action filed in California pending the outcome of the motion to dismiss in *Witriol v. Conexant, et al.* The Company has negotiated a similar agreement with the plaintiffs in the New Jersey case, which is subject to approval by the court. Pursuant to the stay agreements, in the event that the parties in the *Witriol* case engage in any negotiations, plaintiffs' counsel in the derivative cases will be allowed to participate. The defendants believe the charges in these cases are without merit and intend to vigorously defend the litigation.



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**ITEM 6. EXHIBITS**

Exhibits:

- 10.1 Dwight W. Decker Performance Share Award Grant Letter and Terms and Conditions filed as Exhibit 10.2 to the Company's Current Report on Form 8-K dated May 9, 2005 (File No. 000-24923), is incorporated herein by reference.
- 31.1 Certification of the Chief Executive Officer of Periodic Report Pursuant to Rule 13a-15(e) or 15d-15(e).
- 31.2 Certification of the Chief Financial Officer of Periodic Report Pursuant to Rule 13a-15(e) or 15d-15(e).
- 32 Certification by Chief Executive Officer and Chief Financial Officer of Periodic Report Pursuant to 18 U.S.C. Section 1350.

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**SIGNATURE**

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

CONEXANT SYSTEMS, INC.  
(Registrant)

Date: August 9, 2005

By /s/ J. Scott Blouin  
J. Scott Blouin  
Senior Vice President and  
Chief Financial Officer  
(principal financial officer)  
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**EXHIBIT INDEX**

- 31.1 Certification of the Chief Executive Officer of Periodic Report Pursuant to Rule 13a-15(e) or 15d-15(e).
- 31.2 Certification of the Chief Financial Officer of Periodic Report Pursuant to Rule 13a-15(e) or 15d-15(e).
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