

CONEXANT SYSTEMS INC

Form 10-Q

August 16, 2004

**Table of Contents**

---

---

**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, 2004\***

**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.)

**100 Schulz Drive**  
**Red Bank, New Jersey 07701**  
(Address of principal executive offices) (Zip code)

**(732) 345-7500**  
(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 30, 2004 was 468,764,918.

---

\* For presentation purposes of this Form 10-Q, references made to the June 30, 2004 period relate to the actual fiscal third quarter ended July 2, 2004.

---



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

This Quarterly Report contains statements relating to future results of Conexant Systems, Inc. (including certain projections and business trends) that are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, and are subject to the safe harbor created by those sections. Our actual results may differ materially from those projected as a result of certain risks and uncertainties. These risks and uncertainties include, but are not limited to: the cyclical nature of the semiconductor industry and the markets addressed by our products and our customers' products; demand for and market acceptance of new and existing products; successful development of new products; the timing of new product introductions; the availability of manufacturing capacity; pricing pressures and other competitive factors; changes in product mix; product obsolescence; our ability to develop and implement new technologies and to obtain protection of the related intellectual property; the uncertainties of litigation; the risk that the businesses of Conexant and GlobespanVirata will not be integrated successfully, as well as other risks and uncertainties, including those set forth herein and those detailed from time to time in our filings with the Securities and Exchange Commission. These forward-looking statements are made only as of the date hereof, and we undertake no obligation to update or revise the forward-looking statements, whether as a result of new information, future events or otherwise.

2

---

**CONEXANT SYSTEMS, INC.****INDEX**

	<b><u>PAGE</u></b>
<b><u>PART I. FINANCIAL INFORMATION</u></b>	
<b><u>Item 1. Financial Statements (unaudited):</u></b>	
<u>Consolidated Condensed Balance Sheets – June 30, 2004 and September 30, 2003</u>	4
<u>Consolidated Condensed Statements of Operations – Three and Nine Months Ended June 30, 2004 and 2003</u>	5
<u>Consolidated Condensed Statements of Cash Flows – Nine Months Ended June 30, 2004 and 2003</u>	6
<u>Notes to Consolidated Condensed Financial Statements</u>	7
<b><u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u></b>	24
<b><u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u></b>	44
<b><u>Item 4. Controls and Procedures</u></b>	45
<b><u>PART II. OTHER INFORMATION</u></b>	
<b><u>Item 2. Changes in Equity Securities, Use of Proceeds and Issuer Purchases of Equity Securities</u></b>	46
<b><u>Item 6. Exhibits and Reports on Form 8-K</u></b>	46
<u>Signature</u>	47
<u>EXHIBIT 31.1</u>	
<u>EXHIBIT 31.2</u>	
<u>EXHIBIT 32</u>	

3

**Table of Contents****PART I. FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****CONEXANT SYSTEMS, INC.****Consolidated Condensed Balance Sheets**  
**(unaudited, in thousands, except per share amounts)**

	<b>June 30, 2004</b>	<b>September 30, 2003</b>
<b>ASSETS</b>		
<b>Current assets:</b>		
Cash and cash equivalents	\$ 78,549	\$ 76,186
Short-term investments	158,293	99,283
Receivables, net of allowance of \$1,258 and \$1,547 at June 30, 2004 and September 30, 2003, respectively	213,904	79,557
Inventories	145,551	59,548
Deferred income taxes	13,631	13,600
Mindspeed warrant-current portion	11,700	
Other current assets	31,828	26,524
	<hr/>	<hr/>
Total current assets	653,456	354,698
Property, plant and equipment, net	84,251	36,310
Goodwill	705,689	56,865
Intangible assets, net	143,393	12,506
Deferred income taxes	242,445	241,260
Mindspeed warrant	69,151	119,230
Marketable securities	188,045	
Other assets	133,083	110,838
	<hr/>	<hr/>
Total assets	<b>\$ 2,219,513</b>	<b>\$ 931,707</b>
	<hr/>	<hr/>
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
<b>Current liabilities:</b>		
Accounts payable	\$ 128,211	\$ 55,909
Accrued compensation and benefits	49,584	28,865
Restructuring and reorganization liabilities	20,798	12,091
Other current liabilities	68,111	24,816
	<hr/>	<hr/>
Total current liabilities	266,704	121,681
Convertible subordinated notes	711,825	581,825
Other liabilities	74,436	61,435

Total liabilities	<u>1,052,965</u>	<u>764,941</u>
Commitments and contingencies		
<b>Shareholders' equity:</b>		
Preferred and junior preferred stock		
Common stock, \$0.01 par value: 1,000,000 shares authorized; 466,315 and 276,134 shares issued, and 465,665 shares and 276,134 shares outstanding at June 30, 2004 and September 30, 2003, respectively	4,663	2,761
Treasury stock: 650 shares at cost	(4,778)	
Additional paid-in capital	4,643,743	3,506,070
Accumulated deficit	(3,506,685)	(3,332,527)
Accumulated other comprehensive income (loss)	58,723	(9,496)
Notes receivable from stock sales	(2,292)	
Unearned compensation	<u>(26,826)</u>	<u>(42)</u>
Total shareholders' equity	<u>1,166,548</u>	<u>166,766</u>
Total liabilities and shareholders' equity	<u>\$ 2,219,513</u>	<u>\$ 931,707</u>

See accompanying notes to consolidated condensed financial statements.

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

	<b>Three months ended</b>		<b>Nine months ended</b>	
	<b>June 30,</b>		<b>June 30,</b>	
	<b>2004</b>	<b>2003</b>	<b>2004</b>	<b>2003</b>
Net revenues	\$267,617	\$ 150,950	\$ 688,731	\$ 435,274
Cost of goods sold (including \$812 for the nine months ended June 30, 2004 related to restructuring actions in the merger-Notes 3 and 7)	<u>155,136</u>	<u>86,000</u>	<u>395,448</u>	<u>245,569</u>
Gross margin	112,481	64,950	293,283	189,705
Operating expenses:				
Research and development (including non-cash stock compensation of \$2,237 and \$3,131 for the three and nine months ended June 30, 2004, respectively, and \$45 and \$444 for the three and nine months ended June 30, 2003, respectively)	74,317	38,849	167,205	117,827
Selling, general and administrative (including non-cash stock compensation of \$743 and \$1,029 for the three and nine months ended June 30, 2004, and \$0 and \$1,272 for the three and nine months ended June 30, 2003, respectively)	36,371	22,915	89,782	69,471
Amortization of intangible assets	7,956	925	12,564	2,523
In-process research and development			160,818	
Special charges	<u>8,294</u>	<u>6,526</u>	<u>14,413</u>	<u>13,585</u>
Total operating expenses	<u>126,938</u>	<u>69,215</u>	<u>444,782</u>	<u>203,406</u>
Operating loss	(14,457)	(4,265)	(151,499)	(13,701)
Gain on extinguishment of debt		(7,376)		(42,021)
Other (income) expense, net	<u>56,308</u>	<u>(544)</u>	<u>21,291</u>	<u>40,785</u>
Income (loss) before income taxes	(70,765)	3,655	(172,790)	(12,465)
Provision for income taxes	<u>661</u>	<u>488</u>	<u>1,368</u>	<u>1,185</u>

Edgar Filing: CONEXANT SYSTEMS INC - Form 10-Q

Income (loss) from continuing operations	(71,426)	3,167	(174,158)	(13,650)
Loss from discontinued operations, net of income taxes		(52,297)		(728,877)
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Net loss	\$ (71,426)	\$ (49,130)	\$ (174,158)	\$ (742,527)
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Income (loss) per share, basic:				
Continuing operations	\$ (0.15)	\$ 0.01	\$ (0.48)	\$ (0.05)
Discontinued operations		(0.19)		(2.73)
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Net loss	\$ (0.15)	\$ (0.18)	\$ (0.48)	\$ (2.78)
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Income (loss) per share, diluted:				
Continuing operations	\$ (0.15)	\$ 0.01	\$ (0.48)	\$ (0.05)
Discontinued operations		(0.19)		(2.73)
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Net loss	\$ (0.15)	\$ (0.18)	\$ (0.48)	\$ (2.78)
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Number of shares used in per share computation-basic	463,804	268,469	363,654	266,915
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Number of shares used in per share computation-diluted	463,804	271,051	363,654	266,915
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>

See accompanying notes to consolidated condensed financial statements.



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

	<b>Nine months ended June 30,</b>	
	<b>2004</b>	<b>2003</b>
<b>Cash flows from operating activities:</b>		
Loss from continuing operations	\$(174,158)	\$ (13,650)
Adjustments to reconcile loss from continuing operations to net cash provided by (used in) operating activities, net of effects of disposition of business and acquisitions:		
Depreciation	11,337	13,576
Amortization of intangible assets	12,564	2,523
In-process research and development	160,818	
Asset impairments	4,534	8,092
Provision for losses on accounts receivable		(3,912)
Inventory provisions	6,046	12,597
Decrease in fair value of Skyworks note and Mindspeed warrant	44,671	76
Write-down of non-marketable investments	600	34,402
Equity in (earnings) losses of equity method investees	(12,750)	3,233
Gain of extinguishment of debt		(42,021)
Gain of sale of investments	(27,017)	(5,228)
Other non-cash items, net	7,334	8,148
Changes in assets and liabilities:		
Receivables	(42,174)	(22,410)
Inventories	(18,631)	(16,238)
Accounts payable	30,131	(4,974)
Accrued expenses and other current liabilities	8,942	1,157
Other	(10,589)	5,612
	<u>1,658</u>	<u>(19,017)</u>
<b>Cash flows from investing activities:</b>		
Cash received in (paid for) acquisitions, net	24,752	(6,796)
Payment of acquisition related costs	(29,764)	
Advances to Skyworks		(35,000)
Repayment of Term Notes and advances by Skyworks		170,000
Purchases of marketable securities	(67,816)	(73,511)
Sales of marketable securities	38,384	132,900
Capital expenditures	(13,922)	(13,555)
Proceeds from sales of assets and investments	31,580	15,378
Payment of deferred purchase consideration	(4,000)	
Investments in businesses	(2,619)	(4,500)

Net cash provided by (used in) investing activities	(23,405)	184,916
	<u>          </u>	<u>          </u>
<b>Cash flows from financing activities:</b>		
Proceeds from exercise of stock options	24,110	7,275
Repurchase of convertible subordinated notes		(56,378)
	<u>          </u>	<u>          </u>
Net cash provided by (used in) financing activities	24,110	(49,103)
	<u>          </u>	<u>          </u>
Net cash used in discontinued operations		(202,971)
	<u>          </u>	<u>          </u>
Net increase (decrease) in cash and cash equivalents	2,363	(86,175)
Cash and cash equivalents at beginning of period	76,186	161,088
	<u>          </u>	<u>          </u>
Cash and cash equivalents at end of period	\$ 78,549	\$ 74,913
	<u>          </u>	<u>          </u>

See accompanying notes to consolidated condensed financial statements.

**Table of Contents****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, Conexant completed its merger with GlobespanVirata, Inc. (GlobespanVirata), a provider of broadband communications solutions for consumer, enterprise and service provider markets. Following the merger, GlobespanVirata is a wholly-owned subsidiary of Conexant. In the merger, GlobespanVirata shareholders received 1.198 shares of Conexant common stock for each share of GlobespanVirata common stock and Conexant issued approximately 180.6 million shares. In addition, the outstanding and unexercised common stock options of GlobespanVirata were adjusted and converted into options to purchase 43.6 million shares of Conexant common stock. See Note 2 for further information.

On June 27, 2003, Conexant completed the distribution to Conexant shareholders of all outstanding shares of Mindspeed Technologies, Inc. (Mindspeed), a wholly owned subsidiary of Conexant to which Conexant contributed its Internet infrastructure business, including the stock of certain subsidiaries, and certain other assets and liabilities, including approximately \$100.0 million in cash (hereinafter, the Mindspeed Spin). In the Mindspeed Spin, Conexant shareholders received one share of Mindspeed common stock for every three Conexant shares held and the Conexant shareholders continued to hold their Conexant shares. Mindspeed issued to Conexant a warrant to purchase 30.0 million shares of Mindspeed common stock, representing approximately 20 percent of Mindspeed's outstanding common stock on a fully diluted basis at the time of the Mindspeed Spin. The warrant is exercisable for a period of ten years, commencing one year after the completion of the Mindspeed Spin, at an exercise price of \$3.408 per share (the fair market value on the date of grant). The warrant is recorded as an asset on the consolidated condensed balance sheet (see Note 3) and changes in the estimated fair value of the warrant are recorded in other (income) expense. Additionally, Conexant entered into a senior secured revolving credit facility pursuant to which Mindspeed may borrow up to \$50.0 million for working capital and general corporate purposes. See Note 10 for further information.

The operating results of the discontinued Mindspeed Technologies Internet infrastructure business (through June 27, 2003) included in the accompanying unaudited consolidated condensed statements of operations were as follows (in thousands):

<b>Three months ended June 30,</b>	<b>Nine months ended June 30,</b>
--	---

	<u>2003</u>	<u>2003</u>
Net revenues	\$ 20,153	\$ 58,719
Loss before income taxes	\$(52,095)	\$(155,231)
Provision for income taxes	202	462
Cumulative effect of change in accounting for goodwill		(573,184)
Loss from discontinued operations	\$(52,297)	\$(728,877)

**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

**Table of Contents**

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

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, 2003.

**Fiscal Periods** For presentation purposes, references made to the periods ended June 30, 2004 and 2003 relate to the actual fiscal 2004 third quarter ended July 2, 2004 and the actual fiscal 2003 third quarter ended June 27, 2003, respectively.

**Supplemental Cash Flow Information** Cash paid for interest was \$16.6 million and \$15.6 million for the nine months ended June 30, 2004 and 2003, respectively. Cash paid for income taxes for the nine months ended June 30, 2004 and 2003 was \$0.2 million and \$1.8 million, respectively. See Note 2 for a discussion of the common stock and options issued and net assets acquired in acquisitions.

**Loss Per Share** Basic 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.

The following table sets forth the computation of the numerator and denominator of basic and diluted earnings per share:

	Three months ended June 30,		Nine months ended June 30,	
	2004	2003	2004	2003
<b>Numerator (dollars in thousands):</b>				
Income (loss) from continuing operations	\$ (71,426)	\$ 3,167	\$(174,158)	\$ (13,650)
Loss from discontinued operations, net of income taxes		(52,297)		(728,877)
Net loss	<u>\$ (71,426)</u>	<u>\$ (49,130)</u>	<u>\$(174,158)</u>	<u>\$(742,527)</u>
<b>Denominator (weighted-average number of shares in thousands):</b>				
Weighted average shares outstanding- basic	463,804	268,489	363,654	266,915
Stock options and warrants (under the treasury stock method)		2,562		
Weighted average shares outstanding - diluted	463,804	271,051	363,654	266,915

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 June 30,		Nine months ended June 30,	
	2004	2003	2004	2003
Stock options and warrants (under the treasury stock method)	21,734		24,239	1,150
4.25% Convertible Subordinated Notes due 2006	7,364	5,962	7,364	5,918
4% Convertible Subordinated Notes due 2007	12,137	9,859	12,137	10,902
5.25% Convertible Subordinated Notes due 2006	5,840		2,695	
Restricted stock	10		15	81

**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 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.

**Table of Contents**

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

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 loss from continuing operations and pro forma loss from continuing operations per share would have been the amounts indicated below (in thousands, except per share amounts):

	<b>Three months ended June 30,</b>		<b>Nine months ended June 30,</b>	
	<b>2004</b>	<b>2003</b>	<b>2004</b>	<b>2003</b>
Income (loss) from continuing operations, as reported	\$(71,426)	\$ 3,167	\$(174,158)	\$(13,650)
Add: expense determined under fair value accounting included in loss from continuing operations, as reported	2,980	45	4,160	1,716
Deduct: total expense determined under fair value accounting for all awards	<u>(18,693)</u>	<u>(11,040)</u>	<u>(43,071)</u>	<u>(46,519)</u>
Pro forma loss from continuing operations	<u>\$(87,139)</u>	<u>\$ (7,828)</u>	<u>\$(213,069)</u>	<u>\$(58,453)</u>
Income (loss) from continuing operations per share basic, as reported	\$ (0.15)	\$ 0.01	\$ (0.48)	\$ (0.05)
Pro forma loss from continuing operations per share basic	\$ (0.19)	\$ (0.03)	\$ (0.59)	\$ (0.22)
Income (loss) from continuing operations per share diluted, as reported	\$ (0.15)	\$ 0.01	\$ (0.48)	\$ (0.05)
Pro forma loss from continuing operations per share diluted	\$ (0.19)	\$ (0.03)	\$ (0.59)	\$ (0.22)

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:

	<b>Three months ended June 30,</b>		<b>Nine months ended June 30,</b>	
	<b>2004</b>	<b>2003</b>	<b>2004</b>	<b>2003</b>
Risk-free interest rate	3.93%	3.18%	3.33%	3.18%
Expected volatility	97%	97%	97%	97%

Dividend yield					
Expected life (years)	4.5	4.5	2.5	4.5	4.5
Weighted-average fair value of options granted	\$3.63	\$2.02	\$5.04		\$1.33

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 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.

**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 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



**Table of Contents**

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

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, 2004 and at September 30, 2003 are as follows (in thousands):

	<b>June 30, 2004</b>	<b>September 30, 2003</b>
Cash and cash equivalents	\$ 78,549	\$ 76,186
Skyworks 15% convertible senior subordinated notes		55,566
Equity securities- Skyworks Solutions, Inc. (6.2 million shares at June 30, 2004, 0.5 million shares at September 30, 2003)	50,824	4,576
Equity securities- SiRF Technologies, Inc. (5.9 million shares at June 30, 2004)	74,582	
Other short-term marketable securities (primarily U.S. government agencies and corporate debt securities)	32,887	39,141
Subtotal- short-term investments	158,293	99,283
Long-term marketable securities (primarily U.S. government agencies and corporate debt securities)	188,045	
	<b>\$424,887</b>	<b>\$ 175,469</b>

For all investment securities, unrealized losses that are other than temporary are recognized in net income. The Company does not hold these securities for speculative or trading purposes.

**Reclassifications** Certain prior year amounts have been reclassified to conform to the current year presentation.

## 2. Acquisitions

### *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. For accounting purposes, the transaction was accounted for under the

purchase method of accounting with the Company as the acquiror. In exchange for 100% of the outstanding shares of common stock of GlobespanVirata (approximately 150.7 million shares), the Company issued 1.198 shares of Conexant common stock for each share of GlobespanVirata common stock outstanding (or approximately 180.6 million shares of Conexant common stock) and each outstanding option and warrant to purchase GlobespanVirata common stock was adjusted and converted into an option or warrant to purchase Conexant common stock based on the 1.198 merger ratio (or approximately 43.6 million options to purchase shares of Conexant common stock). 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 purchase consideration is summarized as follows (in thousands):

Fair market value of Conexant common stock issued	\$1,027,342
Fair value of Conexant common stock options issued	81,011
Transaction costs	<u>12,900</u>
 Total purchase consideration	 <u>\$1,121,253</u>

The fair value of Conexant common stock and stock options issued of \$1.1 billion has been allocated to common stock and additional paid in capital. The fair market value of the 180.6 million shares of common stock issued was determined using a per share price of \$5.69 (the average of the closing market prices of Conexant common stock on the day of the announcement of the Merger, November 3, 2003, and on the three business days before and after the announcement date). In accordance with FASB Interpretation No. 44 Accounting for Certain Transactions Involving Stock Compensation, the \$111.9 million fair value of the 43.6 million Conexant common stock options granted to replace the acquired common stock options was determined using a Black-Scholes option pricing model with the following assumptions: market price of \$5.69 per share, volatility of 97%, risk-free rate of return of 3.2%, expected lives of 4.5 years and no dividend yield. Approximately \$30.9 million in intrinsic value associated with

**Table of Contents**

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

the unvested stock options has been allocated to unearned compensation and will be amortized to expense over the average remaining vesting period of approximately 2.6 years. A total of \$3.0 million and \$4.1 million of this unearned compensation was recognized as an expense in the three and nine months ended June 30, 2004, respectively.

In connection with the Merger, the Company began to formulate a reorganization and restructuring plan (the Reorganization Plan). As a result of the Reorganization Plan, the Company recorded restructuring and asset impairment charges related to Conexant's operations of \$6.1 million and \$9.4 million during the three and nine months ended June 30, 2004, respectively. These charges are included in Special Charges and Cost of Goods Sold in the accompanying consolidated condensed statement of operations. Additionally, the Company initially recognized \$14.8 million as liabilities assumed in the purchase business combination related to restructuring liabilities for estimated costs related to Conexant, Inc. facilities consolidation and the related impact on Conexant, Inc. outstanding real estate leases and Conexant, Inc. involuntary employee terminations and relocations. In the quarter ended June 30, 2004, these liabilities were reduced by \$3.6 million against the purchase price allocation (goodwill) for certain facilities related decisions. These liabilities were included in the allocation of the purchase price in accordance with SFAS No. 141 entitled "Business Combinations" and EITF 95-3 entitled "Recognition of Liabilities in Connection with a Purchase Business Combination". Finalization and execution of the Reorganization Plan is not yet complete and further actions may be taken such as additional or different facilities impairments, workforce reductions or relocations and/or product related decisions with respect to duplicate technology licenses, duplicate maintenance contracts, production masks and inventory of goods for which there will no longer be an active market for the combined company. The Reorganization Plan and its related actions are expected to be completed by the end of calendar 2004, and when taken, charges and/or reductions will be recorded as an adjustment to goodwill. Any actions relating to the acquiring corporation will be charged against operations. See Note 7 for a further description of the Company's reorganization and restructuring plans.

The following sets forth the Company's estimates of the fair values of the assets acquired and liabilities assumed in the Merger as of February 27, 2004 (in thousands). These amounts have been adjusted for the \$3.6 million Reorganization Plan changes described above, and other liability reductions totaling \$2.4 million. The amounts below may change further as the Reorganization Plan is completed.

Cash and cash equivalents	\$ 42,515
Short-term and long-term investments	153,099
Accounts receivable	91,259
Inventories	73,281
Prepays and other current assets	4,056
Property and equipment	46,883
Other long-term assets	20,600
Identifiable intangible assets	137,931
In-process research and development	160,818
Goodwill	629,387
Accounts payable	(41,580)
Accrued expenses	(75,062)
Accrued restructuring and reorganization liabilities	(11,255)
Long-term debt	(130,000)
Other long-term liabilities	(23,284)

Treasury stock	9,188
Notes receivable from stock sales	2,469
Unearned compensation	<u>30,948</u>
Net assets acquired	<u>\$1,121,253</u>

**Table of Contents**

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

The excess of the purchase price over the fair value of the net tangible assets acquired has been reflected as identifiable intangible assets and goodwill. The identifiable intangible assets and respective useful lives are as follows (in thousands):

Product licenses (7 years)	\$ 10,964
Trademark (7 years)	2,006
Developed technologies (2 - 5 years)	124,961
	<hr/>
Total identifiable intangible assets	\$ 137,931
	<hr/>

The identifiable intangible assets were valued using the income approach and a discount rate of 18%. The developed technologies consist of eight products in the digital subscriber line (DSL) and wireless local area network (LAN) categories. Under the income approach, the fair value reflects the present value of the projected cash flows that are expected to be generated by the products incorporating the current technology. The type of income approach utilized for the trademark was the relief from royalty methodology, under which an estimate is made as to the appropriate royalty income that would be negotiated in an arm's length transaction if the subject intangible asset were licensed from an independent third party owner. These assets are being amortized on a straight-line basis over their estimated useful lives ranging from 2 to 7 years, with a weighted-average life of approximately 5 years. Amortization expense for these intangible assets was \$6.9 million and \$9.6 million for the three and nine months ended June 30, 2004, respectively. The amount recorded as goodwill of \$629.4 million is not deductible for tax purposes.

The amount allocated to in process research and development (IPR&D) of \$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 two IPR&D projects relating to the development of DSL and wireless LAN products. The DSL project represented 70% of the total IPR&D acquired. Both projects were approximately 87% complete at the date of the merger. The estimated costs to complete for the DSL and wireless LAN projects were approximately \$14.1 million and \$6.2 million, respectively. These projects will be completed in fiscal 2005. 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.

Management is responsible for the amounts determined for IPR&D as well as developed technologies and believes that that amounts are representative of fair values. Through June 30, 2004, actual results do not materially differ from the estimates used in the valuations of IPR&D or developed technologies.

The treasury stock of \$9.2 million represents the value of the 1.25 million shares of Conexant common stock held by iCompression, a subsidiary of the former GlobespanVirata, which were effectively repurchased at the acquisition date of February 27, 2004.

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. The following unaudited pro forma information represents a summary of the results of operations as if the Merger occurred at the beginning of each period presented and includes amortization of identifiable intangibles and unearned compensation from that date.

	<b>Three months ended June 30,</b>	<b>Nine months ended June, 30</b>	
	<b>2003</b>	<b>2004</b>	<b>2003</b>
Net revenues	\$225,325	\$ 875,507	\$ 629,459
Net loss	\$ (62,799)	\$(198,051)	\$(803,475)
Net loss per common share - basic and diluted	\$ (0.14)	\$ (0.43)	\$ (1.80)

**Table of Contents**

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

The pro forma results are based on various assumptions and are not necessarily indicative of what would have occurred had the merger closed on October 1, 2003 and 2002, respectively.

***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 \$2.6 million. The excess of the purchase price over the net tangible assets was assigned to developed technology of \$4.2 million and \$19.6 million to goodwill. The developed technology will be amortized on a straight-line basis over five years. The amount recorded as goodwill of \$19.6 million is not deductible for tax purposes. The purchase price allocation is preliminary and is subject to change.

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 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 \$4.0 million during the twelve to eighteen months following the acquisition 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.

The pro forma effect of this acquisition was not material to the Company's results of operations for fiscal 2004 or 2003.

**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, 2004:</b>				
U.S. government agencies	\$28,138	\$	\$ (91)	\$ 28,047
Foreign government securities	502			502
Corporate debt securities	1,797		(16)	1,781
Equity securities	57,374	72,289	(1,700)	127,963
	<u>57,374</u>	<u>72,289</u>	<u>(1,700)</u>	<u>127,963</u>
	\$87,811	\$72,289	\$(1,807)	\$158,293
	<u>\$87,811</u>	<u>\$72,289</u>	<u>\$(1,807)</u>	<u>\$158,293</u>
<b>September 30, 2003:</b>				
Skyworks 15% convertible senior subordinated notes	\$46,542	\$ 9,024	\$	\$ 55,566
U.S. government agencies	14,640	25	(18)	14,647
Foreign government securities	2,044	15		2,059
Corporate debt securities	21,625	74	(59)	21,640
Equity securities	2,320	3,051		5,371
	<u>2,320</u>	<u>3,051</u>	<u></u>	<u>5,371</u>
	\$87,171	\$12,189	\$ (77)	\$ 99,283
	<u>\$87,171</u>	<u>\$12,189</u>	<u>\$ (77)</u>	<u>\$ 99,283</u>



**Table of Contents**

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

The Company accounted for the Skyworks 15% convertible senior subordinated notes as available-for-sale securities carried at their fair value. Unrealized gains or losses resulting from changes in the fair value of the underlying debt were included in other comprehensive income. The right to convert the Skyworks 15% convertible senior subordinated notes into shares of Skyworks common stock was, for financial accounting purposes, an embedded derivative instrument. Changes in the fair value of the Skyworks 15% convertible senior subordinated notes resulting from changes in the value of the conversion right were included in other (income) expense, net each period. During the quarter ended June 30, 2004, the Company converted the notes into 5.7 million shares of Skyworks common stock at the conversion price of \$7.87 per share (see Note 4).

<b>Long-term investments (in thousands):</b>	<b>Amortized Cost</b>	<b>Gross Unrealized Holding Gains</b>	<b>Gross Unrealized Holding Losses</b>	<b>Fair Value</b>
<b>June 30, 2004:</b>				
U.S. government agencies	\$ 159,033	\$	\$(806)	\$ 158,227
Corporate debt securities	29,974	—	(156)	29,818
	<u>\$ 189,007</u>	<u>—</u>	<u>\$(962)</u>	<u>\$ 188,045</u>

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

**Inventories**

Inventories consist of the following (in thousands):

	<b>June 30, 2004</b>	<b>September 30, 2003</b>
Work-in-process	\$ 74,629	\$ 42,662
Finished goods	70,922	16,886
	<u>\$ 145,551</u>	<u>\$ 59,548</u>

In the quarter ended March 31, 2004, as a result of strategic decisions made at the time of the Merger, the Company wrote down \$0.8 million of on-hand inventory products which will no longer be actively marketed or sold. This amount was charged to cost of goods sold.

***Goodwill***

During the first nine months of fiscal 2004, goodwill was adjusted as follows (in thousands):

Goodwill, September 30, 2003	\$ 56,865
Merger	<u>635,261</u>
Goodwill, March 31, 2004	692,126
Adjustment to purchase price allocations	(5,999)
Acquisitions	<u>19,562</u>
Goodwill, June 30, 2004	<u>\$705,689</u>

***Intangible Assets***

Intangible assets consist of the following (in thousands):

	<b>June 30, 2004</b>			<b>September 30, 2003</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	\$145,893	\$(18,065)	\$127,828	\$15,904	\$ (7,456)	\$ 8,448
Customer base	2,050	(725)	1,325	2,050	(358)	1,692
Other intangible assets	20,908	(6,668)	14,240	7,443	(5,077)	2,366
	<u>\$168,851</u>	<u>\$(25,458)</u>	<u>\$143,393</u>	<u>\$25,397</u>	<u>\$(12,891)</u>	<u>\$12,506</u>

**Table of Contents**

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

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 2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>Thereafter</b>
Amortization expense	\$ 8,206	\$31,624	\$29,881	\$29,157	\$28,714	\$15,811

***Mindspeed Warrant***

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, 2004, the aggregate fair value of the Mindspeed warrant included on the accompanying consolidated condensed balance sheet was \$80.9 million. The current portion of \$11.7 million was determined using current pricing data, and the remaining portion was valued using a Black-Scholes model with terms for portions of the warrant varying from 1 to 5 years, volatility of 90%, a risk-free interest rate of 3.2% and no dividend yield. It is the Company's intent to liquidate the portion of this warrant classified as current in the next twelve months.

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.

***Convertible Subordinated Notes***

The Company and its consolidated subsidiaries have three issues of convertible subordinated notes, including the 5.25% convertible subordinated notes due May 2006 which were acquired in the Merger. At June 30, 2004, the components of convertible subordinated notes are as follows (in thousands):

4.0% 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
	<hr/>
Total convertible subordinated notes	\$711,825
	<hr/>

The significant terms of the 5.25% convertible subordinated notes acquired by the Company in the Merger in February 2004 are as follows: The 5.25% convertible subordinated notes are unsecured obligations of Conexant, Inc., are contractually subordinated in right of payment to all senior indebtedness of Conexant, Inc., and mature on May 15, 2006. The holders may convert the notes into shares of Conexant common stock at any time prior to maturity at a

conversion price of \$22.262 per share, subject to adjustment. On and after May 20, 2004, Conexant, Inc. at its option may redeem the notes at any time, in whole or in part, at the redemption price shown in the notes, plus accrued interest, if any. Through June 30, 2004, none of the 5.25% Convertible Subordinated Notes have been redeemed.

Table of Contents

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

*Other (Income) Expense, Net*

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

	<b>Three months ended June 30,</b>		<b>Nine months ended June 30,</b>	
	<b>2004</b>	<b>2003</b>	<b>2004</b>	<b>2003</b>
Investment and interest income	\$ (1,404)	\$(3,585)	\$ (6,703)	\$(13,134)
Decrease in fair value of Skyworks 15% convertible senior subordinated notes	17,837	76	6,292	1,832
Decrease in fair value of the Mindspeed warrant	60,924		38,379	
Interest expense	8,373	6,254	22,322	21,424
Equity in (earnings) losses of equity method investees	(1,934)	2,423	(12,750)	3,233
Gains on sales of investments	(27,017)	(5,228)	(27,017)	(5,228)
Write down of non-marketable investments			600	34,402
Other	(471)	(484)	168	(1,744)
	<u>\$ 56,308</u>	<u>\$ (544)</u>	<u>\$ 21,291</u>	<u>\$ 40,785</u>

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 an entity 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.

During the quarter ended June 30, 2004, SiRF Technology Holdings, Inc. (SiRF) completed its initial public offering of shares of its common stock at a public offering price of \$12.00 per share. The Company sold approximately 2.5 million shares in the SiRF offering for net proceeds of \$28.2 million and recorded a related gain of \$26.5 million, which is included in gains on sales of investments above.

**4. Skyworks Notes**

In November 2002, the Company restructured its previous financing agreements with 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**

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.

***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

**Table of Contents**

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

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 Defendants' 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.

**Agere Systems, Inc.** On October 17, 2002, Agere Systems, Inc. (Agere) filed suit against Intersil Corporation (Intersil) in the U.S. District Court of Delaware. Conexant, Inc. acquired the WLAN Group of Intersil in August 2003. Agere alleges that Intersil infringes certain of its U.S. patents. Intersil has counterclaimed against Agere for infringement of certain patents, some of which are now owned by the Company's Conexant, Inc. subsidiary and licensed to Intersil for purposes of the suit. The parties have filed a stipulated order adding Conexant, Inc. as a party to the suit. On July 22, 2003, Agere filed a separate suit against Intersil in the U.S. District Court of Delaware alleging that Intersil infringes certain additional U.S. patents. Conexant, Inc. has also been added as a party to this action. Conexant, Inc. has the benefit of an indemnity and/or warranty from Intersil which the Company believes limits Conexant, Inc.'s liability for monetary damages related to these suits, but the possibility exists that the court could issue an injunction against future sales of affected wireless products. The Company believes that this litigation is unlikely to have a material adverse effect on its business, financial condition, or results of operations.

On October 30, 2002, Intersil and certain of its affiliated companies filed a suit against Agere in the U.S. District Court for the District of Philadelphia alleging that Agere misappropriated certain Media Access Control Wireless Local Area Network technology. This action seeks an injunction to prevent Agere, either alone or in cooperation with others, from developing, making, and/or selling products that use that technology. Agere has made similar counterclaims against Conexant, Inc. and its affiliated companies and Intersil and its affiliated companies. As a result of the acquisition of Intersil's WLAN Products Group and its Choice-Intersil Microsystems, Inc. subsidiary, which is a party to this suit and the only remaining plaintiff, Conexant, Inc. has become involved in this suit. Conexant, Inc. has the benefit of an indemnity and/or warranty from Intersil which the Company believes limits Conexant, Inc.'s liability for monetary damages, but the possibility exists that the court could issue an injunction against future sales of affected wireless products. The Company believes that this litigation is unlikely to have a material adverse effect on its business, financial condition, or results of operations.

**IPO Litigation.** In November 2001, Collegeware Asset Management, LP, on behalf of itself and a putative class of persons who purchased Conexant, Inc. common stock 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 Conexant, Inc.'s initial and secondary public offerings as well as certain Conexant, Inc.

officers and directors. The complaint alleges that the defendants violated federal securities laws by issuing and selling Conexant, 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 approximately 300 other actions making similar allegations regarding the public offerings of hundreds of other companies during 1998 through 2000. In June 2003, the issuers, the individual defendants and plaintiffs reached a tentative settlement agreement that would, among other things, result in the dismissal with prejudice of all claims against Conexant, Inc. s officers and directors. The settlement remains subject to a number of conditions, including class certification



**Table of Contents**

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

and approval of the settlement by the court. It is possible that the parties will not reach agreement on the final settlement or 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 believes that the Conexant, Inc. officers and directors have meritorious defenses to the plaintiffs' claims and expects that those defendants will defend themselves vigorously. The Company also believes that it has sufficient insurance coverage to cover any indemnification obligations to the directors and officers related to this litigation.

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 or results of operations of the Company.

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 currently estimates the aggregate remaining costs for these remediations to be approximately \$3.0 million and has accrued for these costs as of June 30, 2004.

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 \$15.5 million and \$12.5 million for the nine months ended June 30, 2004 and 2003, respectively.

At June 30, 2004, future minimum lease payments under operating leases were as follows (in thousands):

**Fiscal Year**

2004 remaining 3 months	\$ 7,220
2005	23,370
2006	18,563
2007	14,876
2008	11,059
Thereafter	63,431
	<hr/>
Total future minimum lease payments	\$ 138,519
	<hr/>

The summary of future minimum lease payments includes an aggregate of \$18.3 million of lease obligations that principally expire through fiscal 2011, which have been accrued for in connection with the Company's reorganization and restructuring actions (see Note 7).

The Company purchases a portion of its requirements for silicon-based semiconductor products from Jazz Semiconductor, Inc. (Jazz). During the first two years of the long-term supply arrangement entered into with Jazz in March 2002, the Company's cost of wafers was an amount which approximated its historical cost. Thereafter, the cost of wafers is based on market prices. Additionally, the Company is obligated to purchase certain minimum annual volumes of wafers during the first three years of the arrangement. In the event the Company's actual wafer purchases are less than the required minimum volumes, it will be required to make additional payments to Jazz. The Company's expected minimum purchase obligations under the long-term supply agreement with Jazz, net of a portion of the wafer purchase obligations assumed by a third party, will be approximately \$6.6 million for the remainder of fiscal year 2004 and \$13.1 million in fiscal 2005.

**Table of Contents**

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

Additionally, the Company entered into a long-term supply agreement with Skyworks in June 2002, under which Skyworks provides semiconductor assembly and test services at the Company's former Mexicali, Mexico facility. Under this supply agreement, the Company is obligated to purchase certain minimum amounts of assembly and test services for the remainder of fiscal 2004 and for fiscal 2005 in the amounts of \$4.4 million and \$10.9 million, respectively. In the event the Company's purchases of assembly and test services are less than the required minimum amounts, it will be required to make additional payments to Skyworks.

The Company currently anticipates meeting each of the annual minimum purchase obligations under the long-term supply agreements with Jazz and Skyworks.

At June 30, 2004, the Company is contingently liable for approximately \$26.7 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 certain non-marketable equity investments, the Company may be required to invest up to an additional \$6.2 million as of June 30, 2004.

**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>2004</b>	<b>2003</b>	<b>2004</b>	<b>2003</b>
Net loss	\$(71,426)	\$(49,130)	\$(174,158)	\$(742,527)
Other comprehensive income (loss):				
Foreign currency translation adjustments	(556)	700	346	1,327
Reclassification adjustment-accumulated translation adjustment- discontinued operations		17,617		17,713
Change in unrealized gains on available-for-sale securities, net of tax	65,762	934	67,441	1,537
Minimum pension liability adjustments	87	(213)	260	1,382
Effect of income taxes			172	
	<u>65,293</u>	<u>19,038</u>	<u>68,219</u>	<u>21,959</u>
Other comprehensive income				
Comprehensive loss	<u>\$ (6,133)</u>	<u>\$(30,092)</u>	<u>\$(105,939)</u>	<u>\$(720,568)</u>

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

	<b>June 30, 2004</b>	<b>September 30, 2003</b>
	<u>          </u>	<u>          </u>
Foreign currency translation adjustments	\$ (2,677)	\$ (3,023)
Unrealized gains on available-for-sale securities, net of tax	69,520	1,907
Minimum pension liability adjustments	(8,120)	(8,380)
	<u>          </u>	<u>          </u>
Accumulated other comprehensive income (loss)	\$58,723	\$ (9,496)
	<u>          </u>	<u>          </u>

## 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>2004</b>	<b>2003</b>	<b>2004</b>	<b>2003</b>
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Asset impairments	\$2,508	\$5,611	\$ 4,534	\$ 8,092
Restructuring charges	3,627		4,075	1,904
Integration charges	1,565		4,168	
Other	594	915	1,636	3,589
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
	\$8,294	\$6,526	\$14,413	\$13,585
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>

**Table of Contents**

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

***Asset Impairments***

During the first nine months of 2003, the Company recorded asset impairment charges of \$8.1 million, related to leasehold improvements associated with properties no longer occupied by the Company and other assets that management determined to abandon or scrap.

During the first nine months of 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***

In fiscal 2002 and continuing into fiscal 2003, the Company implemented a number of cost reduction initiatives to improve its operating cost structure. The cost reduction initiatives included workforce reductions, temporary shutdowns of the Company's manufacturing facilities, significant reductions in capital spending, the closure or consolidation of certain facilities and salary reductions for the senior management team until the Company returned to profitability. In the second and third quarters of fiscal 2004 in connection with the Merger, the Company implemented further workforce reductions and facility consolidations. The Company continuously evaluates the business in light of current market and competitive conditions to ensure that operating expenses are in line with expectations of revenue levels. As a result, future periods may require further actions to reduce operating expenses.

The costs and expenses associated with all the restructuring activities are included in special charges in the accompanying consolidated condensed statements of operations.

*2002 Corporate and Manufacturing Restructuring Plan* During fiscal 2002, the Company initiated a further 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 of its former wireless communications division. 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 unfavorable sublease experience to date, and charged an additional \$1.5 million to restructuring expense. 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, 2004 were as follows (in thousands):

	<b>Workforce reductions</b>	<b>Facility and other</b>	<b>Total</b>
	<u>          </u>	<u>          </u>	<u>          </u>
Charged to costs and expenses	\$ 2,437	\$12,519	\$14,956
Cash payments	<u>(1,664)</u>	<u>(431)</u>	<u>(2,095)</u>
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	<u>(3,173)</u>	<u>(3,930)</u>	<u>(7,103)</u>
Restructuring balance, September 30, 2003	498	7,946	8,444
Cash payments	<u>(447)</u>	<u>(3,114)</u>	<u>(3,561)</u>
Restructuring balance, June 30, 2004	<u>\$ 51</u>	<u>\$ 4,832</u>	<u>\$ 4,883</u>

**Table of Contents**

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

*2003 Corporate Restructuring Plan* In the fourth quarter of fiscal 2003, the Company initiated another workforce reduction, closed a design center and consolidated some facilities. The Company involuntarily terminated approximately 35 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. In the first quarter of fiscal 2004, as a continuation of the 2003 Corporate Restructuring Plan, the Company vacated an additional facility and involuntarily terminated additional employees which resulted in an additional \$0.4 million in restructuring expense.

Activity and liability balances related to the 2003 Corporate Restructuring Plan through June 30, 2004 were as follows (in thousands):

	<b>Workforce reductions</b>	<b>Facility and other</b>	<b>Total</b>
	<hr/>	<hr/>	<hr/>
Charged to costs and expenses	\$ 1,181	\$2,830	\$ 4,011
Cash payments	(364)		(364)
	<hr/>	<hr/>	<hr/>
Restructuring balance, September 30, 2003	817	2,830	3,647
Charged to costs and expenses	350	98	448
Cash payments	(1,084)	(755)	(1,839)
	<hr/>	<hr/>	<hr/>
Restructuring balance, June 30, 2004	\$ 83	\$2,173	\$ 2,256
	<hr/>	<hr/>	<hr/>

*2004 Merger Restructuring and Reorganization Plans* In connection with the Merger, in order to achieve operational efficiencies, the Company approved a plan of workforce reductions and facilities consolidation actions. These actions commenced in the quarter ended June 30, 2004 and are expected to continue through the December 2004 quarter. The Company will charge such amounts to restructuring expense in the period when the required actions are taken. As the restructuring progresses, approximately 200 employees of the Company, including approximately 50 employees of Conexant, Inc. in the 2004 Reorganization Plan described below, will be impacted by the actions. Through June 30, 2004, approximately 150 employees, including approximately 25 employees of Conexant, Inc., have been impacted by the actions. The Company involuntarily terminated approximately 125 employees in the sales and administration, and information technology areas and recorded charges aggregating \$1.9 million based upon estimates of the cost of severance benefits for the affected employees. The Company also recorded restructuring costs of \$1.8 million relating to the consolidation of certain facilities under non-cancelable leases which were vacated.

Activity and liability balances related to the 2004 Merger Restructuring Plan through June 30, 2004 were as follows (in thousands):

	<b>Workforce reductions</b>	<b>Facility and other</b>	<b>Total</b>
	<u>          </u>	<u>          </u>	<u>          </u>
Charged to costs and expenses	\$ 1,877	\$ 1,750	\$ 3,627
Cash payments	(733)	(86)	(819)
	<u>          </u>	<u>          </u>	<u>          </u>
Restructuring balance, June 30, 2004	\$ 1,144	\$ 1,664	\$ 2,808
	<u>          </u>	<u>          </u>	<u>          </u>

In connection with the Merger, the Company also began to formulate the 2004 Reorganization Plan, which consisted primarily of workforce reductions to eliminate redundant positions and consolidation of the worldwide facilities of Conexant, Inc. In accordance with EITF 95-3 and SFAS No. 141, the estimated costs of \$11.3 million related to these actions were accrued as liabilities as part of the purchase price allocation (see Note 2).

As a result of the 2004 Reorganization Plan, approximately 50 employees of Conexant, Inc. will be part of an involuntary workforce reduction. These employees are primarily located in the United States in sales and administrative functions. The workforce related charges of \$1.3 million were based upon estimates of the severance and fringe benefits for the affected employees, in addition to relocation benefits for others. The plan for consolidation of worldwide facilities consisted of vacating or impairing properties and leases. This resulted in an initial charge of \$13.5 million and included assumptions regarding sublease rates and time periods and other costs to



**Table of Contents**

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

prepare and sublease those spaces. Additionally, as of the date of the Merger, there had been a decline in the real estate market in certain geographic regions in which Conexant, Inc. has lease facilities. A portion of the facilities-related charges represent adjustments to fair market value rates of those leases. These non-cancelable lease commitments range from near term to 17 years in length. In the quarter ended June 30, 2004, certain decisions were made in relation to two operating facilities. As a result, \$3.6 million of accrued facility charges were reduced against the purchase price allocation (goodwill). Future adjustments to the 2004 Reorganization Plan as currently intended, whether favorable or unfavorable, will be recorded as an adjustment to the purchase price allocation.

Activity and liability balances related to the 2004 Reorganization Plan through June 30, 2004 were as follows (in thousands):

	<u>Workforce reductions</u>	<u>Facility and other</u>	<u>Total</u>
Recorded in purchase price allocation	\$ 1,300	\$ 13,509	\$ 14,809
Cash payments	—	(89)	(89)
Restructuring balance, March 31, 2004	1,300	13,420	14,720
Adjusted to purchase price allocation	—	(3,554)	(3,554)
Cash payments	(73)	(242)	(315)
Restructuring balance, June 30, 2004	<u>\$ 1,227</u>	<u>\$ 9,624</u>	<u>\$ 10,851</u>

At June 30, 2004, the Company has a remaining accrued restructuring and reorganization liability balance of \$20.8 million. The Company expects to pay the amounts accrued for the workforce reductions through fiscal 2005 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 and reorganization 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, 2004, the Company incurred \$1.6 million and \$4.2 million, respectively, of costs related to the integration efforts of the employees, customers, operations and other business aspects related to the Merger.

**Other**

Other special charges in the first nine months of 2003 principally consist of a \$2.7 million loss on the sale of certain

semiconductor test equipment. Other special charges in the three months ended June 30, 2004 of \$0.6 million principally consist of 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

The Company operates and tracks its results in one reportable segment (see Note 1).

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

	Three months ended June 30,		Nine months ended June 30,	
	2004	2003	2004	2003
Americas	\$ 29,499	\$ 15,565	\$ 77,442	\$ 50,593
Asia-Pacific	215,797	125,606	554,457	352,581
Europe, Middle East and Africa	22,321	9,779	56,832	32,100
	\$267,617	\$150,950	\$688,731	\$435,274

The Company believes a substantial 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

**Table of Contents**

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

Americas and Europe. For the three and nine months ended June 30, 2004, no customer accounted for 10% of net revenues. For each of the three and nine months ended June 30, 2003, two customers (foreign resellers) accounted for 22% of net revenues. No other customer accounted for 10% or more of the Company's net revenues for the three or nine months ended June 30, 2003.

**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, 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. (Jazz), 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 facility or 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 these guarantees and indemnities in the accompanying consolidated balance sheets. Product warranty costs are not significant.

**10. Mindspeed Credit Facility**

In connection with the Mindspeed Spin, the Company entered into a senior secured revolving credit facility pursuant to which Mindspeed may borrow up to \$50.0 million for working capital and general corporate purposes. Mindspeed may borrow under the credit facility only to restore its cash balance to \$25.0 million. Borrowings accrue interest at 10% per annum, payable at maturity, and are collateralized by substantially all the assets of Mindspeed. The credit facility expires on June 29, 2007. As of June 30, 2004, no amounts were outstanding under the credit facility.

In connection with the credit facility, Mindspeed issued to the Company warrants to purchase up to approximately 8.3 million shares of Mindspeed common stock. The number of shares that may be acquired under the warrants will depend on the level of borrowings under the credit facility, increasing pro rata as the principal balance of Mindspeed's borrowings increases. The warrants will be exercisable for a period of ten years after the Mindspeed Spin at a price per share equal to the fair market value of a share of Mindspeed common stock at the time of issuance of the warrants or at the time of the borrowing that entitles the Company to acquire shares thereunder, whichever is lower.

**11. Related Party Transaction**

As of June 30, 2004, loans originally made by the former GlobespanVirata, Inc. to certain executive officers of the Company, were outstanding in the principal amount of approximately \$2.7 million, with accrued interest of approximately \$0.8 million. Subsequent to June 30, 2004, those loans were settled.



**Table of Contents**

**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, 2003.

**Overview**

Except where otherwise noted, this discussion of our financial condition and results of operations represents our continuing operations, excluding our discontinued Mindspeed Technologies business which we spun off in June 2003. See Note 1 of Notes to Consolidated Condensed Financial Statements for further information on this transaction.

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 chip sets 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 35% of net revenues in the first nine months of fiscal 2004. No customer accounted for 10% of our net revenues in the first nine months of fiscal 2004. Our top 20 customers accounted for approximately 58% of net revenues for the first nine months of fiscal 2004. Revenues derived from customers located in the Americas, Europe and the Asia-Pacific region were 11%, 8% and 81%, respectively, of our net revenues for the first nine months of fiscal 2004. We believe a substantial 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.

**Recent Developments**

On February 27, 2004, we completed our merger with GlobespanVirata, Inc., or GlobespanVirata, a provider of broadband communications solutions for consumer, enterprise and service provider markets, hereinafter referred to as the Merger. In May 2004, GlobespanVirata was renamed Conexant, Inc. See Note 2 of Notes to Consolidated

Condensed Financial Statements for further information. The results of operations of Conexant, Inc. have been included in our consolidated results commencing February 28, 2004, and are therefore included for the full quarter ended June 30, 2004 and only four months of the nine months ended June 30, 2004.

**Table of Contents**

If the Merger had been completed on January 1, 2004, the net revenues for the combined companies for the full quarter ended March 31, 2004 would have been \$293.3 million, or \$49.5 million higher than the reported net revenues of \$243.8 million. Our actual revenues for the quarter ended June 30, 2004 were \$267.6 million, or a decrease of approximately 9% from the pro forma prior quarter amount. This sequential decrease in revenues was predominately attributable to a sequential decline in our wireless LAN product line revenues as a result of reduced demand due to low-priced solutions emerging in the Taiwanese market, which has caused pricing pressure and increased channel inventories at our customers. We expect that net revenues for the quarter ending September 30, 2004 will decline sequentially from the \$267.6 million net revenues in the quarter ended June 30, 2004 as a result of channel inventory levels at our direct customers, distributors and resellers.

The use of net revenues for the combined companies as if the Merger had closed at the beginning of the quarter ended March 31, 2004 is a non-GAAP financial measure, is used by management to provide useful information in establishing a meaningful comparison of sequential revenue levels which is not necessarily reflected in the results of operations as presented below. It is not intended to be an alternative to GAAP measures.

At the time of the Merger, we announced certain workforce reductions and facilities consolidation actions in order to achieve operational efficiencies. Certain of these actions have been taken, and others have yet to be executed. The cost savings of these actions has not yet been fully reflected in our operating results for the periods discussed below. 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 the actions taken to date, or possible future actions, have or will inhibit our ability to invest in appropriate levels of research and development growth areas and be competitive in the marketplace.

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

We recognize revenues from product sales upon shipment and transfer of title, in accordance with the shipping terms specified in the arrangement with the direct customer, distributor, or other reseller. Revenue recognition is deferred in all instances where the earnings process is incomplete. We sell a portion of our products to electronic component distributors under agreements allowing for a right to return unsold products. We defer the recognition of revenue on all sales to these distributors until the products are sold by the distributors to a third party. We record a reserve for sales returns and allowances for direct customers and other resellers based on historical experience or specific identification of an event necessitating a reserve. Development revenue is recognized when services are performed and was not significant for any of the periods presented. The following table summarizes our net revenues:

(in millions)	Three months ended			Change from March 2004 Quarter	Change from June 2003 Quarter
	June 30, 2004	March 31, 2004	June 30, 2003		
Net revenues	\$267.6	\$243.8	\$151.0	10%	77%
	<b>Nine months ended June 30,</b>				

	<u>2004</u>	<u>2003</u>	<u>Change</u>
Net revenues	\$688.7	\$435.3	58%

Net revenues for the three months ended June 30, 2004, increased \$116.6 million or 77% over the comparable period in 2003. The increase is attributable to increased volumes of DSL and wireless LAN products associated with the Merger, as well as increases in sales of satellite set-top box solutions, convergence video products using MPEG codec technology and higher speed document imaging products and soft modem product revenues from the PCTEL business acquired in the third quarter of fiscal 2003.

Net revenues for the nine months ended June 30, 2004 increased \$253.4 million or 58% over the comparable period in 2003. This increase is associated with increased unit shipments of our DSL and wireless LAN products associated with the Merger, as well as the increase in sales of satellite set-top box solutions, convergence video



**Table of Contents**

products using MPEG codec technology, higher speed document imaging products and embedded modem solutions and soft modem product revenues from the PCTEL business acquired in the third quarter of fiscal 2003.

Net revenues for the three months ended June 30, 2004 increased \$23.8 million or 10% sequentially from the previous quarter. The increase was driven by increased volume shipments of DSL and wireless LAN products associated with the Merger.

**Gross Margin**

(in millions)	Three months ended			Change from March 2004 Quarter	Change from June 2003 Quarter
	June 30, 2004	March 31, 2004	June 30, 2003		
Gross margin	\$112.5	\$101.7	\$65.0	11%	73%
Percent of net revenues	42%	42%	43%		
	Nine months ended June 30,				
	2004	2003	Change		
Gross margin	\$293.3	\$189.7	55%		
Percent of net revenues	43%	44%			

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 quarter of fiscal 2004 was 42% compared with the similar period of fiscal 2003 gross margin of 43%. The gross margin percentage decrease is attributable to the effects of additional revenues of lower margin products and the decreased average selling prices experienced in the current competitive environment which were offset by cost reduction actions.

Our gross margin for the first nine months of fiscal 2004 was 43% compared with the similar period of fiscal 2003 gross margin of 44%. Gross margin would have been 41% in the 2003 period excluding the sales of inventory previously written down to zero cost. The increase from year to year in adjusted gross margin percentage reflects the additional revenues from our higher margin universal access and convergence video products, as well as reductions in vendor inventory prices.

When compared with the immediately preceding quarter, our gross margins for the third quarter of fiscal 2004 stayed constant at 42% of net revenues.

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. Once established, these write-downs are considered permanent adjustments to the cost basis of the excess inventory. Permanent write-downs are typically a consequence of specific events. For example during 2001, we experienced sharply reduced end-customer demand when the overall communication semiconductor market declined swiftly and dramatically, resulting in a significant number of order cancellations and a decline in the volume of new orders. These events triggered a permanent impairment of certain of our inventory.

Our gross margin for the first nine months of fiscal 2003 benefited from the sale of inventories with an original cost of \$10.9 million, respectively, that we had written down to a zero cost basis during fiscal year 2001. Our gross

**Table of Contents**

margin for the three months ended June 30, 2003 did not benefit from these zero cost inventory sales. These sales resulted from renewed demand for certain products that was not anticipated at the time of the write-downs. The previously written-down inventories were generally sold at prices which exceeded their original cost. Had we not previously written down the cost basis of these goods, our cost of goods sold would include the original cost of such goods, and our gross margin for the first nine months of fiscal 2003 would have been \$178.8 million (41% of our net revenues). As of June 30, 2003, all such inventories had been scrapped or sold.

On an operational basis and unrelated to any significant single event we assess the recoverability of our inventories at least quarterly through a review of inventory levels in relation to foreseeable demand (generally over six to twelve months). Foreseeable demand is based upon all available information, including sales backlog and forecasts, product marketing plans and product life cycles. When the inventory on hand exceeds the foreseeable demand, we reserve for the excess which, at the time of our review, we expect to be unable to sell. The amount of the inventory reserve is the excess of historical cost over estimated realizable value.

We base our assessment of the recoverability of our inventories, and the amounts of any reserves, on currently available information and assumptions about future demand and market conditions. 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 reserves may be required.

Under our long-term supply arrangement with Jazz Semiconductor, Inc. (Jazz), we are obligated to purchase certain minimum annual volumes of wafers through March 2005. Additionally, under a long-term supply agreement with Skyworks, we are obligated to purchase certain minimum amounts of assembly and test services during fiscal years 2004 and 2005. In the event our actual purchases under these arrangements are less than the required minimum volumes, we will be required to make additional payments, which would adversely affect our gross margin. We currently anticipate meeting each of the annual minimum purchase obligations under the long-term supply agreements with Jazz and Skyworks.

**Research and Development**

(in millions)	Three months ended			Change from March 2004 Quarter	Change from June 2003 Quarter
	June 30, 2004	March 31, 2004	June 30, 2003		
Research and development	\$ 74.3	\$ 53.7	\$38.8	38%	92%
Percent of net revenues	28%	22%	26%		
	Nine months ended June 30,				
	2004	2003	Change		
Research and development	\$167.2	\$117.8	42%		
Percent of net revenues	24%	27%			

Our research and development (R&D) expenses consist principally of direct personnel costs to develop new communications and semiconductor products, photomask 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 the unvested stock options exchanged in the Merger.

The \$35.5 million increase in R&D expenses for the third quarter of fiscal 2004 compared to the similar period of fiscal 2003 primarily reflects additional development costs associated with DSL and wireless LAN products as a result of the Merger, an increase of \$2.2 million in stock compensation charges as a result of the Merger, and to a much lesser extent, increased R&D project costs associated with increases in labor, purchased R&D and electronic design automation tools.

The \$49.4 million increase in R&D expenses for the nine months ended June 30, 2004 compared to the similar period of fiscal 2003 primarily reflects additional headcount to support the development of DSL and wireless LAN products as a result of the Merger, an increase of \$2.7 million in stock compensation charges as a result of the

**Table of Contents**

Merger, and to a much lesser extent, increased R&D project costs associated with labor, purchased R&D, electronic design automation tools and recruiting.

When compared to the immediately preceding quarter, R&D increased \$20.6 million to \$74.3 million from \$53.7 million. This increase reflects additional development costs associated with DSL and wireless LAN products as a result of the Merger, and an increase of \$1.4 million in stock compensation charges as a result of the Merger. In addition, R&D project costs also increased as labor, photomask and electronic design automation tool costs were slightly higher.

**Selling, General and Administrative**

(in millions)	Three months ended			Change from March 2004 Quarter	Change from June 2003 Quarter
	June 30, 2004	March 31, 2004	June 30, 2003		
Selling, general and administrative	\$ 36.4	\$ 30.6	\$ 22.9	19%	59%
Percent of net revenues	14%	13%	15%		
	Nine months ended June 30,				
	2004	2003	Change		
Selling, general and administrative	\$ 89.8	\$ 69.5	29%		
Percent of net revenues	13%	16%			

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, real estate, information systems, customer service, sales, marketing, field application engineering and other services and non-cash stock compensation charges related to the amortization of the unvested stock options exchanged in the Merger.

The \$13.5 million and \$20.3 million increases in SG&A expense for the three and nine months ended June 30, 2004, respectively, compared to the same periods of fiscal 2003 are attributable to additional SG&A costs as a result of the Merger, a \$0.7 million increase in stock compensation charges in the three months ended June 30, 2004 and reductions in bad debt charges in the nine months ended June 30, 2003 associated with improving collections experience at that time.

When compared to the immediately preceding quarter, SG&A expense increased \$5.8 million to \$36.4 million from \$30.6 million. This increase reflects additional SG&A costs as a result of the Merger and a \$0.5 million increase in stock compensation charges.

**Amortization of Intangible Assets**

(in millions)	Three months ended June 30,			Nine months ended June 30,		
	2004	Change	2003	2004	Change	2003
Amortization of intangible assets	\$ 8.0	nm	\$ 0.9	\$ 12.6	nm	\$ 2.5
Percent of net revenues	nm		nm	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 new 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 three and nine months ended June 30, 2004 compared to the three and nine months ended June 30, 2003 is primarily attributable to additional intangibles acquired in an acquisition in the latter half of fiscal 2003 and the Merger completed on February 27, 2004. See Note 2 of Notes to Consolidated

**Table of Contents**

Condensed Financial Statements for further information. We expect that amortization of intangible assets will be approximately \$8.2 million for the remainder of fiscal 2004.

**In-Process Research and Development**

(in millions)	Three months ended June 30,			Nine months ended June 30,		
	2004	Change	2003	2004	Change	2003
In-process research and development	\$	nm	\$	\$160.8	nm	\$
Percent of net revenues	nm		nm	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 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,		
	2004	Change	2003	2004	Change	2003
Restructuring charges	\$3.6	nm	\$	\$4.1	nm	\$1.9
Asset impairment charges	2.5	nm	5.6	4.5	nm	8.1
Integration charges	1.6	nm		4.2	nm	
Other special charges	0.6	nm	0.9	1.6	nm	3.6
	<u>\$8.3</u>		<u>\$6.5</u>	<u>\$14.4</u>		<u>\$13.6</u>

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.

**Other (Income) Expense, Net**

(in millions)	Three months ended June 30,			Nine months ended June 30,		
	2004	Change	2003	2004	Change	2003
Other (income) expense, net	\$56.3	nm	\$(0.5)	\$21.3	nm	\$40.8
Percent of net revenues	nm		nm	nm		nm

nm= not meaningful

Other expense, net for the first nine months of fiscal 2004 was comprised of 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 note prior to its conversion into Skyworks common stock in May 2004, \$22.3 million of interest expense primarily from our convertible subordinated notes, and impairments of non-marketable investments of \$0.6 million, offset by \$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 Semiconductor), \$27.0 million in gains of sales of certain of our investments and assets, and \$6.7 million of investment and interest income on invested cash balances. The \$11.4 million gain in our investment in Jazz Semiconductor is the result of our ownership in Jazz decreasing from 45% to approximately 38% when the additional favorable investment was realized. Due to variations in the fair value of the common stock underlying the Mindspeed warrant, we expect that other (income) expense may fluctuate significantly in future periods until this derivative instrument is liquidated.

Other expense, net for the first nine months of the previous year was comprised of \$13.1 million of investment and interest income on invested cash balances, a gain on the sale of an investment of \$5.2 million, more than offset by a



## **Table of Contents**

\$1.8 million decrease in the fair value of the conversion right under the Skyworks 15% convertible senior subordinated notes, \$3.2 million of losses in our equity method investments, \$21.4 million of interest expense primarily from our convertible subordinated notes, and impairments of non-marketable investments of \$34.4 million.

As a result of the acquisition of \$130.0 million of the 5.25% convertible subordinated notes in the Merger, interest expense in the three and nine months ended June 30, 2004 was higher than in the three and nine months ended June 30, 2003. Additionally, as a result of the acquisition of approximately \$195.6 million in cash, short-term and long-term investments in the Merger, investment and interest income in the three and nine months ended June 30, 2004 was higher than in the three and nine months ended June 30, 2003.

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 for which we have accounted 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 \$1.4 million and \$1.2 million for the nine months ended June 30, 2004 and 2003, respectively, primarily reflecting taxes imposed on our foreign subsidiaries. No federal income tax expense was recorded with respect to the results for both periods as they will be offset by net operating loss carryovers that have not been previously recognized. Except to the extent of the federal alternative minimum tax, 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.

As of September 30, 2003, Conexant had generated \$668.0 million of deferred tax assets and as of December 31, 2003 Conexant, Inc. had \$338.0 million of fully reserved deferred tax assets, both of which are available to offset future tax obligations subject to limitations imposed by section 382 of the Internal Revenue Code. We had a valuation allowance of approximately \$413.0 million for the generated deferred tax assets that we do not expect to realize through the reduction of future income tax payments. We believe the remaining portion of our deferred tax assets will be realized based on our current expectations of future earnings and tax planning strategies available to us. We evaluate the realizability of our deferred tax assets quarterly and in the event that we determine that we will not be able to realize all or part of our generated deferred tax assets in the future, an adjustment to the deferred tax assets would be charged or credited to income in the period such determination is made. To the extent that we realize a benefit from the acquired deferred tax assets, the benefit will be credited to goodwill.

## **Liquidity and Capital Resources**

Our cash and cash equivalents increased by \$2.4 million during the first nine months of fiscal 2004. Cash provided by operating activities was \$1.7 million for the first nine months of fiscal 2004, compared to cash used in operating activities of \$19.0 million for the comparable period in fiscal 2003. Operating cash flows for the first nine months of fiscal 2004 reflect our loss from continuing operations of \$174.2 million, offset by non-cash charges of \$208.1 million and a net increase in the components of working capital of \$32.3 million. Non-cash charges consist primarily of IPR&D of \$160.8 million, depreciation and amortization of \$23.9 million, a net decrease in fair value of the Mindspeed warrant and the Skyworks convertible notes of \$44.7 million, offset by gains on sales of assets and investments of \$27.0 million, and a net increase in equity in earnings of equity method investees of \$12.8 million. The working capital increase principally consists of a \$42.2 million increase in accounts receivable, an \$18.6 million increase in inventories, and a \$10.6 million increase in other assets/liabilities, primarily increased prepaid expenses, offset by a \$39.1 million increase in accounts payable and accrued expenses, all attributable to the timing of sales and

purchases at quarter end.

Cash used in investing activities of \$23.4 million for the first nine months of fiscal 2004 includes net cash and cash equivalents acquired in acquisitions of \$24.8 million, capital expenditures of \$13.9 million, net purchases of

**Table of Contents**

marketable securities of \$29.4 million, payment of deferred purchase consideration of \$4.0 million, payment of acquisition costs of \$29.8 million, and investments of \$2.6 million. Cash provided by investing activities of \$184.9 million in the first nine months of fiscal 2003 principally consisted of the repayment of the Skyworks note (net of the credit facility of \$35.0 million), \$15.4 million in proceeds from the sale of assets and investments, \$59.4 million of net sales of marketable securities, partially offset by capital expenditures of \$13.6 million and an acquisition of a business of \$6.8 million.

Cash provided by financing activities of \$24.1 million for the first nine months of fiscal 2004 consisted of proceeds from the exercise of stock options, and cash used by financing activities in the first nine months of fiscal 2003 consisted of \$56.4 million in repurchases of convertible subordinated notes offset by \$7.3 million from the exercise of stock options.

As of June 30, 2004, our principal sources of liquidity are our existing cash reserves and marketable securities (of which there is a short-term and a long-term portion), the current portion of the Mindspeed warrant and cash generated from product sales. Our working capital at June 30, 2004 was \$386.8 million compared to \$233.0 million at September 30, 2003. In addition, at June 30, 2004, we held \$188.0 million in long-term marketable securities which we could liquidate to fund operations and/or future acquisitions.

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

<b>(in millions)</b>	<b>June 30, 2004</b>	<b>September 30, 2003</b>
Cash and cash equivalents	\$ 78.5	\$ 76.2
Skyworks 15% convertible senior subordinated notes		55.6
Equity securities- Skyworks Solutions, Inc. (6.2 million shares at June 30, 2004, 0.5 million shares at September 30, 2003)	50.8	4.6
Equity securities- SiRF Technologies, Inc. (5.9 million shares at June 30, 2004)	74.6	
Other short-term marketable securities (primarily U.S. government agencies and corporate debt securities)	33.0	39.1
Long-term marketable securities (primarily U.S. government agencies and corporate debt securities)	188.0	
	<u>\$424.9</u>	<u>\$ 175.5</u>

The current portion of the Mindspeed warrant at June 30, 2004 is \$11.7 million, and the long-term portion is \$69.2 million. The valuation of this derivative instrument is subjective, and at any point in time and could ultimately result in the realization of amounts significantly different than the carrying value.

In connection with the Mindspeed Spin in June 2003, we entered into a senior secured revolving credit facility with Mindspeed, pursuant to which Mindspeed may borrow up to \$50.0 million from us for working capital and general corporate purposes. Mindspeed may borrow under the credit facility only to restore its cash balance to \$25.0 million. The credit facility is available through June 29, 2007 and as of June 30, 2004, no amounts were outstanding.

We believe that our existing sources of liquidity will be sufficient to fund our operations, research and development efforts, anticipated capital expenditures, remaining accrued restructuring and reorganization liabilities balance of \$20.8 million, contingent consideration commitments on past acquisitions, and other capital requirements, including our commitment under the credit facility with Mindspeed, 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 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.

**Table of Contents**

The following summarizes our contractual obligations at June 30, 2004:

(in millions)	Payments due by period				
	Total	Less than 1 Year	1-3 years	3-5 years	More than 5 years
Convertible subordinated notes	\$711.8	\$	\$711.8	\$	\$
Operating leases	138.5	24.7	35.6	23.1	55.1
Assigned leases	26.7	3.2	15.9	2.5	5.1
Contingent consideration on acquisitions	4.0		4.0		
Capital commitments	6.2	6.2			
Purchase commitments	35.0	35.0			
	<u>\$922.2</u>	<u>\$ 69.1</u>	<u>\$767.3</u>	<u>\$ 25.6</u>	<u>\$ 60.2</u>

**Off-Balance Sheet Arrangements**

Our off-balance arrangements consist of conventional operating leases, the Mindspeed senior secured revolving credit facility, capital commitments and purchase commitments as described in Notes 5 and 10 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, 2004.

**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), the 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. Additionally, estimates for the purchase price allocation 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

## **Table of Contents**

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 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 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 acquired deferred tax assets, the benefit will be credited to goodwill.

### ***Inventories***

We write down our inventory for estimated obsolescence or unmarketable inventory in an amount equal to the difference between the cost of inventory and the estimated market value based upon assumptions about future demand and market conditions. If actual market conditions are less favorable than our estimates, additional inventory write-downs may be required.

### ***Allowance for doubtful accounts***

We maintain allowances for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. 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. Equity prices, including non-marketable equity securities, have declined significantly over the past two years and 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 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 from product sales is recognized upon shipment to the customer, when the risk of loss has been transferred to the customer, price and terms are fixed, no significant vendor obligation exists and collection of the resulting receivable is reasonably assured. 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



## **Table of Contents**

as sales commissions. In addition, we record reductions to revenue for estimated product returns, and allowances such as competitive pricing programs and rebates. We follow very specific and detailed guidelines in measuring revenue. Revenue results are difficult to predict, and any shortfall in revenues could cause our operating results to vary significantly from period to period.

### ***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 current 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 \$3.6 million and \$4.1 million of restructuring charges in the three and nine months ended June 30, 2004. We recorded \$5.2 million, \$16.1 million and \$16.9 million of restructuring charges in fiscal years 2003, 2002 and 2001, respectively. These charges relate primarily 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. 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 those revisions in the period that they are determined to be necessary. In addition, as a result of the Merger in February 2004, we acquired \$11.3 million (as adjusted) of additional restructuring liabilities which were recorded through the purchase price allocation. Such amounts also contain estimates and assumptions made by management, and will be 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 assumptions do not tend to change materially over time. We evaluate all assumptions annually and they are updated to reflect our experience.

### ***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.

**Table of Contents**

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.

***Each of Conexant, GlobespanVirata and the combined company has recently incurred substantial losses.***

Our net revenues for the three and nine months ended June 30, 2004 were \$267.6 million and \$688.7 million, respectively. Our loss from continuing operations for the three and nine months ended June 30, 2004 was \$71.4 million and \$174.2 million, respectively.

Conexant's net revenues in fiscal 2003 were \$600.0 million compared to \$521.7 million in fiscal 2002 and \$541.7 million in fiscal 2001. Although Conexant had income from continuing operations of \$23.6 million in fiscal 2003, it incurred losses from continuing operations of \$143.8 million in fiscal 2002 and \$660.9 million in fiscal 2001. Including discontinued operations, Conexant incurred net losses of \$705.3 million in fiscal 2003, \$880.8 million in fiscal 2002, and \$1.4 billion in fiscal 2001. GlobespanVirata's net revenues for fiscal 2003 were \$379.1 million compared to \$228.9 million in fiscal 2002 and \$264.9 million in fiscal 2001. GlobespanVirata also had losses from continuing operations of \$49.6 million in fiscal 2003, \$636.9 million in fiscal 2002 and \$372.0 million in fiscal 2001. Including discontinued operations, GlobespanVirata incurred net losses of \$59.3 million in fiscal 2003, \$655.0 million in fiscal 2002, and \$377.5 million in fiscal 2001.

***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.

***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;

**Table of Contents**

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.

***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; and

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

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 able to continue to reduce the cost of our products to remain competitive. If we are unable to reduce manufacturing costs in

response to declines in selling prices for our products, it will lead to declines in gross margins for such products.

***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;

rapid changes in customer requirements;

**Table of Contents**

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 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 Armando Geday, our 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.

***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 40% of Conexant's



**Table of Contents**

net revenues for fiscal 2003, whereas GlobespanVirata's sales were primarily to OEM customers. For the three and nine months ended June 30, 2004, approximately 30% and 35%, respectively, of our sales were to distributors and other resellers. 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.

***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), including Jazz Semiconductor, Inc., in which we hold a minority interest. Under our fabless business model, our long-term 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.

Although we have a long-term supply arrangement with Jazz to obtain external wafer manufacturing capacity, the foundries we use may allocate their limited capacity to fulfill the production requirements of other customers that are larger and better financed than we. 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, including Skyworks Solutions, Inc., 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 above 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, Mexico 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 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 to experience from time to time 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

**Table of Contents**

timely basis. Moreover, lower than anticipated manufacturing yields may adversely affect our cost of goods sold and our results of operations.

*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, 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.

*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 anticipate.*

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:

- 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 businesses 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 expect to result from the merger will be realized within the time periods contemplated or at all.

***We face a risk that capital needed for our business 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. We cannot assure you that we will have access to additional sources of capital on favorable terms or at all.

**Table of Contents**

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

For the three and nine months ended June 30, 2004, approximately 92% 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 and suppliers located outside the United States, including the Skyworks assembly and test facility in Mexico 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 capital and trading markets;

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; and

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

Because most of our international sales, other than sales to Japan (which are denominated principally in Japanese yen), 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.

***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;

**Table of Contents**

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

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. If our operating results fail to meet the expectations of analysts or investors, it could materially and adversely affect the price of our common stock and other securities.

***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;

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.

***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.



**Table of Contents**

***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 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.

***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. In connection with Conexant's spin-off from Rockwell International Corporation (now Rockwell Automation, Inc.) in December 1998, Conexant assumed all liabilities in respect of environmental matters related to the former operations of its business. 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 \$3.0 million and have accrued for these costs as of June 30, 2004.

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 September 30, 2003, Conexant had approximately \$1 billion of U.S. federal income tax net operating loss, or NOL, carryforwards that can be used to offset taxable income in subsequent years. The NOL carryforwards are scheduled to expire at various dates through 2024. Section 382 of the Internal Revenue Code could limit the future use of some or all of the NOL carryforwards 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 carryforwards 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

**Table of Contents**

ownership of GlobespanVirata and the future use of GlobespanVirata's NOL carryforwards are subject to the section 382 limitation (or further limitation in the case of NOL carryforwards 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.

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.

**Table of Contents****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.

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, 2004, 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, 2004, a 10% adverse change in interest rates would result in an \$18.8 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, 2004, a 10% adverse change in equity prices would result in a \$12.8 million decrease in the value of our marketable equity securities.

We classify all of our marketable debt and equity securities as available-for-sale securities. As of June 30, 2004, the carrying value of these securities included net unrealized gain of \$69.5 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, 2004, a 10% decrease in the market price of Mindspeed's common stock would decrease the fair value of this warrant by approximately \$10.8 million. At June 30, 2004, the market price of Mindspeed's common stock was \$4.46 per share. For the quarter ended June 30, 2004, the market price of Mindspeed's common stock ranged from a low of \$4.45 per share to a high of \$7.63 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, 2004:

<b>(in millions)</b>	<b>Carrying Value</b>	<b>Fair Value</b>
Cash and cash equivalents	\$ 78.5	\$ 78.5
Marketable debt securities	31.6	31.6
Marketable government securities	186.8	186.8
Marketable equity securities	128.0	128.0
Mindspeed warrant	80.9	80.9
Long-term debt	711.8	686.3

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, we seek to 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, 2004, we held no foreign currency forward exchange contracts. Based on our overall currency rate exposure at June 30, 2004, a 10% change in the currency rates would not have a material effect on our consolidated financial position, results of operations or cash flows.

**Table of Contents**

**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 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 Exchange Act is recorded, processed, summarized and reported within required time periods. Based upon that evaluation, the Company's 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, 2004 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 2. CHANGES IN SECURITIES, USE OF PROCEEDS AND ISSUER PURCHASES OF EQUITY SECURITIES**

In connection with the acquisition on June 29, 2004 of all of the outstanding capital stock of Amphion Semiconductor Limited by the Company, the Company delivered 600,000 shares of common stock to former Amphion shareholders. The issuance of the shares was pursuant to an exemption from registration under Section 4(2) of the Securities Act of 1933, as amended. The holders of such shares have been granted certain registration rights. The shares are currently held in escrow and are subject to reduction for any indemnity claims that may be made by the Company in connection with the acquisition. The Company received no cash from the issuance of these securities.

**ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K**

(a) Exhibits:

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.

(b) Reports on Form 8-K

Current Report on Form 8-K dated April 26, 2004, furnishing the Company's press release dated April 26, 2004, announcing its financial results for the second quarter ended March 31, 2004. (Item 12)

Amended Current Report on Form 8-K/A dated May 26, 2004, amending the Company's Current Report on Form 8-K dated March 12, 2004 to update the pro forma financial statements relating to the GlobespanVirata merger. (Item 7)

Current Report on Form 8-K dated July 9, 2004, furnishing the Company's press release dated July 6, 2004, announcing its revised outlook for its third fiscal quarter of 2004. (Item 12)

Current Report on Form 8-K dated July 29, 2004, furnishing the Company's press release dated July 29, 2004, announcing its financial results for the third quarter ended June 30, 2004. (Item 12)

Current Report on Form 8-K dated August 12, 2004, furnishing the Company's press release dated August 12, 2004, announcing its appointment of a new chief financial officer. (Items 5 and 7)

**Table of Contents**

**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 16, 2004

By /s/ J. Scott Blouin

---

J. Scott Blouin  
Senior Vice President and  
Chief Financial Officer  
(principal financial officer)



**Table of Contents**

**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).
- 32 Certification by Chief Executive Officer and Chief Financial Officer of Periodic Report Pursuant to 18 U.S.C. Section 1350.