

CONEXANT SYSTEMS INC

Form 10-Q

August 09, 2006

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

**FORM 10-Q**

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
**For the Quarterly Period Ended June 30, 2006**

**OR**

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

**Commission file number: 000-24923**

**CONEXANT SYSTEMS, INC.**

(Exact name of registrant as specified in its charter)

**Delaware**

(State of incorporation)

**25-1799439**

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

**4000 MacArthur Boulevard**

**Newport Beach, California 92660-3095**

(Address of principal executive offices) (Zip code)

**(949) 483-4600**

(Registrant's telephone number, including area code)

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

Yes  No

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

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

Yes  No

As of July 21, 2006, there were 482,722,591 shares of the registrant's common stock outstanding.

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**FORWARD-LOOKING STATEMENTS**

In addition to historical information, this Quarterly Report on Form 10-Q 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 risk that capital needed for our business and to repay our convertible notes will not be available when needed;

the risk that the value of our common stock may be adversely affected by market volatility;

general economic and political conditions and conditions in the markets we address;

the substantial losses we have incurred;

the cyclical nature of the semiconductor industry and the markets addressed by our products and our customers products;

continuing volatility in the technology sector and the semiconductor industry;

demand for and market acceptance of our new and existing products;

our successful development of new products;

the timing of our new product introductions and our product quality;

our ability to anticipate trends and develop products for which there will be market demand;

the availability of manufacturing capacity;

pricing pressures and other competitive factors;

changes in our product mix;

product obsolescence;

the ability of our customers to manage inventory;

our ability to develop and implement new technologies and to obtain protection for the related intellectual property;

the uncertainties of litigation, including claims of infringement of third-party intellectual property rights or demands that we license third-party technology, and the demands it may place on the time and attention of our management and the expense it may place on our company; and

possible disruptions in commerce related to terrorist activity or armed conflict, as well as other risks and uncertainties, including those set forth herein and those detailed from time to time in our other Securities and Exchange Commission filings. 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.

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**CONEXANT SYSTEMS, INC.**  
**Condensed Consolidated Balance Sheets**  
**(unaudited, in thousands, except par value)**

	<b>June 30, 2006</b>	<b>September 30, 2005</b>
<b>ASSETS</b>		
<b>Current assets:</b>		
Cash and cash equivalents	\$ 225,461	\$ 202,704
Marketable securities	140,360	139,306
Restricted cash	8,800	
Receivables, net of allowances of \$774 and \$3,803	145,412	87,240
Inventories	83,476	95,329
Other current assets	19,665	14,701
<b>Total current assets</b>	<b>623,174</b>	<b>539,280</b>
Property, plant and equipment, net	60,949	50,700
Goodwill	711,645	717,013
Intangible assets, net	83,527	106,709
Mindspeed warrant	29,337	33,137
Marketable securities long-term		38,485
Other assets	121,051	96,200
<b>Total assets</b>	<b>\$ 1,629,683</b>	<b>\$ 1,581,524</b>
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
<b>Current liabilities:</b>		
Current portion of long-term debt	\$ 456,500	\$ 196,825
Short-term debt	80,000	
Accounts payable	135,969	108,957
Accrued compensation and benefits	34,181	27,505
Other current liabilities	65,461	63,197
<b>Total current liabilities</b>	<b>772,111</b>	<b>396,484</b>
Long-term debt	250,000	515,000
Other liabilities	89,112	100,947
<b>Total liabilities</b>	<b>1,111,223</b>	<b>1,012,431</b>

Commitments and contingencies (Note 5)

**Shareholders equity:**

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Preferred and junior preferred stock		
Common stock, \$0.01 par value: 1,000,000 shares authorized; 483,820 and 474,683 shares issued; and 482,538 and 473,500 shares outstanding	4,838	4,747
Treasury stock: 1,282 and 1,184 shares, at cost	(5,823)	(5,584)
Additional paid-in capital	4,687,421	4,657,901
Accumulated deficit	(4,154,659)	(4,053,166)
Accumulated other comprehensive loss	(13,169)	(22,012)
Notes receivable from stock sales	(148)	(304)
Unearned compensation		(12,489)
Total shareholders' equity	518,460	569,093
Total liabilities and shareholders' equity	\$ 1,629,683	\$ 1,581,524

See accompanying notes to condensed consolidated financial statements.

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**CONEXANT SYSTEMS, INC.**  
**Condensed Consolidated 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>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
Net revenues	\$ 251,635	\$ 197,464	\$ 724,924	\$ 507,823
Cost of goods sold <sup>(1)</sup>	137,598	122,430	408,924	365,661
Gain on cancellation of supply agreement	(17,500)		(17,500)	
Gross margin	131,537	75,034	333,500	142,162
Operating expenses:				
Research and development <sup>(1)</sup>	70,096	66,282	199,286	209,362
Selling, general and administrative <sup>(1)</sup>	27,037	31,081	101,958	89,449
Amortization of intangible assets	7,520	7,969	23,185	24,402
Special charges	32,610	8,409	72,379	41,262
Total operating expenses	137,263	113,741	396,808	364,475
Operating loss	(5,726)	(38,707)	(63,308)	(222,313)
Interest expense	10,426	8,396	29,280	25,290
Other expense (income), net	49,907	(15,610)	6,423	(23,367)
Loss before income taxes	(66,059)	(31,493)	(99,011)	(224,236)
Provision for income taxes	1,031	673	2,482	1,835
Net loss	\$ (67,090)	\$ (32,166)	\$ (101,493)	\$ (226,071)
Net loss per share   basic and diluted	\$ (0.14)	\$ (0.07)	\$ (0.21)	\$ (0.48)
Shares used in basic and diluted per-share computation	481,626	471,247	477,716	469,935

<sup>(1)</sup> These captions include non-cash employee stock-based compensation



expense as follows (see Note 1):

	<b>Three Months Ended June 30,</b>		<b>Nine Months Ended June 30,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
Cost of goods sold	\$ 31	\$	\$ 460	\$
Research and development	6,643	2,275	17,791	6,795
Selling, general and administrative	3,502	744	18,993	2,232
<b>Total</b>	<b>\$ 10,176</b>	<b>\$ 3,019</b>	<b>\$ 37,244</b>	<b>\$ 9,027</b>

See accompanying notes to condensed consolidated financial statements.

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

	<b>Nine Months Ended</b>	
	<b>June 30,</b>	
	<b>2006</b>	<b>2005</b>
<b>Cash flows from operating activities:</b>		
Net loss	\$ (101,493)	\$ (226,071)
Adjustments to reconcile net loss to net cash used in operating activities, net of effects of acquisitions:		
Depreciation	14,167	14,054
Amortization of intangible assets	23,185	24,402
Reduction of provision for bad debts	(2,243)	(1,543)
Inventory provisions	1,594	50,150
Decrease in fair value of Mindspeed warrant	3,800	14,804
Losses of equity method investments	3,303	8,587
Gains on sales of equity securities	(4,414)	(42,310)
Gain on cancellation of supply agreement	(17,500)	
Impairment loss of Skyworks shares	18,456	
Stock-based compensation	37,244	9,027
Other non-cash items, net	(2,098)	(299)
Changes in assets and liabilities:		
Receivables	(55,929)	104,386
Inventories	10,063	43,324
Accounts payable	22,610	(47,535)
Agere patent litigation settlement		(8,000)
Special charges and other restructuring related items	(15,371)	(4,241)
Accrued expenses and other current liabilities	13,276	7,947
Other	(2,913)	(5,348)
Net cash used in operating activities	(54,263)	(58,666)
<b>Cash flows from investing activities:</b>		
Payments for acquisitions, net of cash acquired	(6,900)	(18,817)
Restricted cash	(8,800)	
Proceeds from sales of equity securities	5,200	44,360
Purchases of marketable securities	(62,796)	(45,244)
Sales and maturities of marketable securities	89,862	68,831
Net proceeds from purchase and sale-leaseback		49,071
Purchases of property, plant and equipment	(23,500)	(16,426)
Investments in businesses	(705)	(2,580)
Net cash (used in) provided by investing activities	(7,639)	79,195
<b>Cash flows from financing activities:</b>		

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Proceeds from short-term debt, net of expenses of \$1,541	78,459	
Proceeds from long-term debt, net of expenses of \$6,391	243,609	
Repurchases and retirements of long-term debt	(254,684)	
Proceeds from issuance of common stock	17,112	740
Repayment of notes receivable from stock sales	163	196
Net cash provided by financing activities	84,659	936
Net increase in cash and cash equivalents	22,757	21,465
Cash and cash equivalents at beginning of period	202,704	139,031
Cash and cash equivalents at end of period	\$ 225,461	\$ 160,496

See accompanying notes to condensed consolidated financial statements.

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**CONEXANT SYSTEMS, INC.**  
**NOTES TO CONDENSED CONSOLIDATED 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, television 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 and fiber optic networks 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.

**Liquidity** As of June 30, 2006, the Company had a total of \$706.5 million aggregate principal amount of convertible subordinated notes outstanding, of which \$456.5 million is due in February 2007 and \$250.0 million is due in March 2026. The conversion price of the notes due in February 2007 is currently substantially in excess of the market value of the Company's common stock. The Company also has an \$80.0 million credit facility with a bank, under which it had borrowed \$80.0 million as of June 30, 2006. This credit facility has an initial term of 364 days, which expires in November 2006 and which is subject to 364-day renewal periods at the discretion of the bank. As of June 30, 2006, the Company's current liabilities exceeded current assets by \$148.9 million, whereas at September 30, 2005, its current assets exceeded current liabilities by \$142.8 million.

In addition to its \$365.8 million of cash, cash equivalents and marketable securities at June 30, 2006, the Company's principal sources of liquidity will be cash generated from its operations, if any, and additional financing. For the nine months ended June 30, 2006, the Company incurred a net loss of \$101.5 million and negative cash flows from operations of \$54.3 million. Both the net loss and the negative cash flows from operations for the nine months ended June 30, 2006 were negatively impacted by a \$70.0 million patent lawsuit settlement with Texas Instruments, Inc. The Company's cash, cash equivalents and marketable securities include 6.2 million shares of common stock of Skyworks Solutions, Inc. valued at \$34.1 million as of June 30, 2006. For these securities, there is risk associated with the overall state of the stock market, having available buyers for the shares the Company may want to sell, and ultimately being able to liquidate the securities at a favorable price in a short period of time. There can be no assurance that the carrying value of these securities will ultimately be realized. The closing price of Skyworks' common stock on June 30, 2006 and August 4, 2006 was \$5.51 and \$4.44 per share, respectively. This additional per share decline since the end of the Company's third fiscal quarter of 2006 represents an additional decline in the Company's cash, cash equivalents and marketable securities of approximately \$6.6 million.

Based on the Company's current cash flow forecasts, the Company does not believe it will be able to generate sufficient cash flows from its operations and through any liquidation of its investments and other assets in order to meet its February 2007 debt obligations without also obtaining additional financing of approximately \$200 million. The Company is currently evaluating several different financing alternatives and is currently focused on high-yield debt and term loans, as these instruments would not be dilutive to existing shareholders. The Company believes that it will be able to obtain the necessary financing and meet its February 2007 debt obligations; however, it cannot assure you that it will have access to additional sources of financing, or be able to refinance its existing debt, on favorable terms or at all.

The Company also has an investment in Jazz Semiconductor, Inc., a warrant to purchase 30 million shares of Mindspeed Technologies, Inc. common stock, and other assets, including real estate. As a result of current market conditions related to the value of these investments, as well as the Company's limited ability to liquidate these assets, current cash flow forecasts through the due date of the Company's February 2007 debt obligations do not assume any liquidation of these investments. The Company's investment in Jazz is reflected as a long-term asset on the

accompanying condensed consolidated balance sheet as of June 30, 2006. Although Jazz has filed a Registration Statement on Form S-1 regarding its intent to complete an initial public offering of its common stock, Jazz is currently a privately-held company and, as a result, the Company's ability to liquidate this investment is limited. Further, there can be no assurance that Jazz will successfully complete its initial public offering or, if it does, that the

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**(unaudited)**

Company would be able to sell a significant portion of its investment prior to the due date of its February 2007 debt obligations. The value of the Mindspeed warrant of \$29.3 million is also reflected as a long-term asset on the Company's accompanying condensed consolidated balance sheet as of June 30, 2006. The valuation of this derivative instrument is subjective, and at any point in time could ultimately result in the realization of amounts significantly different than the carrying value. Further, there is no assurance that the equity markets would allow the Company to liquidate a substantial portion of this warrant within a short time period without significantly impacting the market value. The closing price of Mindspeed's common stock on June 30, 2006 and August 4, 2006 was \$2.41 and \$1.49 per share, respectively. This additional per share decline since the end of the Company's third fiscal quarter of 2006 represents an additional decline in the value of this warrant.

**Interim Reporting** The accompanying unaudited condensed consolidated financial statements have been prepared by the Company in accordance with accounting principles generally accepted in the United States of America and with the instructions to Form 10-Q and Article 10 of Regulation S-X of the Securities and Exchange Commission. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, the accompanying unaudited condensed consolidated financial statements contain all adjustments, consisting of adjustments of a normal recurring nature, as well as special charges, necessary to present fairly the Company's financial position, results of operations and cash flows. The results of operations for interim periods are not necessarily indicative of the results that may be expected for a full year. These statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended September 30, 2005.

**Fiscal Periods** For presentation purposes, references made to the periods ended June 30, 2006 and 2005 relate to the actual fiscal 2006 third quarter ended June 30, 2006 and the actual fiscal 2005 third quarter ended July 1, 2005, respectively.

**Supplemental Cash Flow Information** Cash paid for interest was \$22.4 million and \$20.0 million for the nine months ended June 30, 2006 and 2005, respectively. Cash paid for income taxes for the nine months ended June 30, 2006 and 2005 was \$1.3 million and \$1.9 million, respectively. Non-cash investing activities for the nine months ended June 30, 2006 consisted of (i) the purchase of \$2.9 million of property and equipment from suppliers on account and (ii) an additional investment in Jazz Semiconductor, Inc. obtained as a result of the termination of a supply agreement (see Note 9).

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

The Company has many distributor customers for whom revenue is recognized upon its shipment of product to them, as the contractual terms provide for no or limited rights of return. During the three months ended December 31, 2004, the Company determined that it was unable to enforce its contractual terms with three distribution customers. As a result, from October 1, 2004, the Company has deferred the recognition of revenue on sales to these three distributors until the purchased products are sold by the distributors to a third party. At June 30, 2006 and September 30, 2005, deferred revenue related to sales to distributors was \$6.9 million and \$6.5 million, respectively. As of June 30, 2006, the Company also has deferred revenue of \$6.5 million related to shipments of products for which the Company has

on-going obligations. Deferred revenue is included in other current liabilities on the accompanying condensed consolidated balance sheets.

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**(unaudited)**

**Shipping and Handling** In accordance with Emerging Issues Task Force (EITF) Issue No. 00-10, Accounting for Shipping and Handling Fees and Costs, the Company includes shipping and handling fees billed to customers in net revenues. Amounts incurred by the Company for freight are included in cost of goods sold.

**Cash and Cash Equivalents** 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.

**Marketable Securities** The Company's marketable securities are classified as available-for-sale and are reported at fair value on the accompanying condensed consolidated balance sheets. Unrealized gains and losses are reported in accumulated other comprehensive income (loss), a component of shareholders' equity on the Company's consolidated balance sheets. Realized gains and losses and declines in value deemed to be other-than-temporary are included in other expense (income), net in the Company's consolidated statements of operations. In determining whether a decline in value is other-than-temporary, the Company evaluates, among other factors, (i) the duration and extent to which the fair value has been less than cost, (ii) the financial condition and near-term prospects of the issuer and (iii) the intent and ability of the Company to retain the investment for a period of time sufficient to allow for any anticipated recovery in fair value. Gains and losses on the sale of available-for-sale securities are determined using the specific-identification method. The Company does not hold any securities for speculative or trading purposes. Beginning in March 2006, the Company considers its available-for-sale portfolio as available for use in its current operations. Accordingly, the Company has classified all marketable securities as short-term, even though the stated maturity dates may be more than one year beyond the current balance sheet date. Prior to March 2006, short-term marketable securities consisted of debt securities with remaining maturity dates of one year or less and equity securities of publicly-traded companies, and long-term marketable securities consisted of debt securities with remaining maturity dates of greater than one year.

**Restricted Cash** Restricted cash represents a contractual cash requirement to collateralize a consolidated subsidiary's obligations under an \$80.0 million credit facility with a bank. For further information regarding the line of credit, see Note 3.

**Stock-Based Compensation** In December 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 123(R), Share-Based Payment. This pronouncement amends SFAS No. 123, Accounting for Stock-Based Compensation, and supersedes Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees. SFAS No. 123(R) requires that companies account for awards of equity instruments issued to employees under the fair value method of accounting and recognize such amounts in their statements of operations. The Company adopted SFAS No. 123(R) on October 1, 2005 using the modified prospective method and, accordingly, has not restated the consolidated statements of operations for prior interim periods or fiscal years. Under SFAS No. 123(R), the Company is required to measure compensation cost for all stock-based awards at fair value on the date of grant and recognize compensation expense in its consolidated statements of operations over the service period that the awards are expected to vest. As permitted under SFAS No. 123(R), the Company has elected to recognize compensation cost for all options with graded vesting granted on or after October 1, 2005 on a straight-line basis over the vesting period of the entire option. For options with graded vesting granted prior to October 1, 2005, the Company will continue to recognize compensation cost over the vesting period following the accelerated recognition method described in FASB Interpretation No. 28, Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans, as if each underlying vesting date represented a separate option grant.

Prior to the adoption of SFAS No. 123(R), the Company accounted for employee stock-based compensation using the intrinsic value method in accordance with APB Opinion No. 25, as permitted by SFAS No. 123 and SFAS No. 148,

Accounting for Stock-Based Compensation Transition and Disclosure. Under the intrinsic value method, the difference between the market price on the date of grant and the exercise price is charged to the statement of operations over the vesting period. Prior to the adoption of SFAS No. 123(R), the Company recognized compensation cost only for stock options issued with exercise prices set below market prices on the date of grant, which consisted



principally of stock options granted to replace stock options of acquired businesses, and provided the necessary pro forma disclosures required under SFAS No. 123.

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

During the three and nine months ended June 30, 2005, the Company recognized compensation expense of \$3.0 million and \$9.0 million, respectively, for stock options under APB Opinion No. 25, which was charged to the consolidated statement of operations. For the three and nine months ended June 30, 2005, had stock-based compensation been accounted for based on the estimated grant date fair values, as defined by SFAS No. 123, the Company's net loss and net loss per share would have been adjusted to the following pro forma amounts (in thousands, except per share amounts):

	<b>Three Months Ended June 30, 2005</b>	<b>Nine Months Ended June 30, 2005</b>
Net loss, as reported	\$ (32,166)	\$ (226,071)
Add: stock-based compensation expense included in reported net loss, net of tax	3,019	9,027
Deduct: stock-based compensation expense determined under fair value method, net of tax	(14,952)	(49,494)
Net loss, pro forma	\$ (44,099)	\$ (266,538)
Net loss per share:		
Basic as reported	\$ (0.07)	\$ (0.48)
Basic pro forma	\$ (0.09)	\$ (0.57)
Diluted as reported	\$ (0.07)	\$ (0.48)
Diluted pro forma	\$ (0.09)	\$ (0.57)

Under SFAS No. 123(R), the Company now records in its consolidated statements of operations (i) compensation cost for options granted, modified, repurchased or cancelled on or after October 1, 2005 under the provisions of SFAS No. 123(R) and (ii) compensation cost for the unvested portion of options granted prior to October 1, 2005 over their remaining vesting periods using the amounts previously measured under SFAS No. 123 for pro forma disclosure purposes. During the three and nine months ended June 30, 2006, the Company recognized compensation expense of \$8.7 million and \$34.2 million, respectively, for stock options and \$1.5 million and \$3.0 million, respectively, for employee stock purchase plan awards in its consolidated statement of operations. Included in the compensation expense recognized during the nine months ended June 30, 2006 is \$1.0 million of stock option modification charges relating to (i) the resignation of the Company's President pursuant to his employment agreement, as amended, and (ii) the resignation of one member of our Board of Directors. These modifications involved the extension of post-resignation exercise periods and an acceleration of vesting for the member of our Board of Directors. Under the transition provisions of SFAS No. 123(R), the Company has recognized a cumulative effect of a change in accounting principle to reduce additional paid-in capital by \$20.7 million, consisting of (i) the remaining \$12.5 million deferred stock-based compensation balance as of October 1, 2005, primarily accounted for under APB Opinion No. 25, and (ii) the \$8.2 million difference between the remaining \$12.5 million deferred stock-based compensation balance as of October 1, 2005 for the options issued in the Company's business combinations and the remaining unamortized grant-date fair value of these options, which also reduced goodwill.

Consistent with the valuation method for the disclosure-only provisions of SFAS No. 123, the Company is using the Black-Scholes-Merton model to value the compensation expense associated with stock-based awards under SFAS No. 123(R). In addition, forfeitures are estimated when recognizing compensation expense, and the estimate of forfeitures will be adjusted over the requisite service period to the extent that actual forfeitures differ, or are expected

to differ, from such estimates. Changes in estimated forfeitures will be recognized through a cumulative catch-up adjustment in the period of change and will also impact the amount of compensation expense to be recognized in future periods.

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

The following weighted average assumptions were used in the estimated grant date fair value calculations for stock options and employee stock purchase plan awards:

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>June 30,</b>	<b>June 30,</b>	<b>June 30,</b>	<b>June 30,</b>
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
Stock option plans:				
Expected dividend yield	0%	0%	0%	0%
Expected stock price volatility	74%	86%	76%	86%
Risk-free interest rate	4.9%	3.8%	4.5%	3.9%
Average expected life (in years)	5.25	5.00	5.25	4.90
Stock purchase plan:				
Expected dividend yield	0%	0%	0%	0%
Expected stock price volatility	76%	79%	76%	89%
Risk-free interest rate	4.4%	4.0%	4.4%	4.1%
Average expected life (in years)	0.50	0.50	0.50	0.50

The expected stock price volatility rates are based on the historical volatility of the Company's common stock. The risk-free interest rates are based on the U.S. Treasury yield curve in effect at the time of grant for periods corresponding with the expected life of the option or award. The average expected life represents the weighted average period of time that options or awards granted are expected to be outstanding, as calculated using the simplified method described in the Securities and Exchange Commission's Staff Accounting Bulletin No. 107.

**Derivative Financial Instruments** The Company's derivative financial instruments as of June 30, 2006 principally consist of (i) the Company's warrant to purchase 30 million shares of Mindspeed Technologies, Inc. common stock and (ii) foreign currency forward exchange contracts. See Note 3 for a discussion of the Mindspeed warrant.

The Company's foreign currency forward exchange contracts are used to hedge certain Indian Rupee-denominated forecasted transactions related to its research and development efforts in India. The foreign currency forward contracts used to hedge these exposures are reflected at their fair value on the balance sheet and meet the criteria for designation as foreign currency cash flow hedges. The criteria for designating a derivative as a hedge include that the hedging instrument should be highly effective in offsetting changes in the designated hedged item. The Company has determined that its non-deliverable foreign currency forward contracts to purchase Indian Rupees are highly effective in offsetting the variability in the U.S. Dollar forecasted cash transactions resulting from changes in the U.S. Dollar / Indian Rupee spot foreign exchange rate. For these derivatives, the gain or loss from the effective portion of the hedge is reported as a component of accumulated other comprehensive income (loss) on the balance sheet and is recognized in the statement of operations in the same period in which the hedged transaction affects operations, and within the same statement of operations line item as the impact of the hedged transaction. The gain or loss is recognized immediately in other expense (income), net in the statement of operations when a designated hedging instrument is either terminated early or an improbable or ineffective portion of the hedge is identified.

At June 30, 2006, the Company had outstanding forward exchange contracts with a notional amount of 607.5 million Indian Rupees, approximately \$13.1 million, maturing at various dates through January 2007. Based on the fair value of these contracts at June 30, 2006, the Company recorded a net asset of \$0.1 million. During the three and nine months ended June 30, 2006, there were no significant gains or losses recognized in the statements of operations for hedge ineffectiveness.

The Company may use other derivatives from time to time to manage its exposure to changes in interest rates, equity prices or other risks. The Company does not enter into derivative financial instruments for speculative or trading purposes.

***Net Income (Loss) Per Share*** Net income (loss) per share is computed in accordance with SFAS No. 128, Earnings Per Share. Basic net income (loss) per share is computed by dividing net income (loss) by the weighted average number of common shares outstanding during the period. Diluted net income (loss) per share is computed by dividing net income (loss) by the weighted average number of common shares outstanding and potentially

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dilutive securities outstanding during the period. Potentially dilutive securities include stock options and warrants and shares of stock issuable upon conversion of the Company's convertible subordinated notes. The dilutive effect of stock options and warrants is computed under the treasury stock method, and the dilutive effect of convertible subordinated notes is computed using the if-converted method. Potentially dilutive securities are excluded from the computations of diluted net income (loss) per share if their effect would be antidilutive.

The following potentially dilutive securities have been excluded from the diluted net income (loss) per share calculations because their effect would have been antidilutive (in thousands):

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>June 30, 2006</b>	<b>June 30, 2005</b>	<b>June 30, 2006</b>	<b>June 30, 2005</b>
Stock options and warrants	20,971	484	13,636	1,290
5.25% convertible subordinated notes due May 2006	2,824	5,840	4,835	5,840
4.25% convertible subordinated notes due May 2006	2,428	7,364	5,718	7,364
4.00% convertible subordinated notes due February 2007	10,758	12,137	11,564	12,137
4.00% convertible subordinated notes due March 2026	46,457		19,209	
Total	83,438	25,825	54,962	26,631

**Recent Accounting Pronouncements** In July 2006, the FASB issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109 (FIN 48). This interpretation clarifies the application of SFAS No. 109, Accounting for Income Taxes, by defining a criterion than an individual tax position must meet for any part of the benefit of that position to be recognized in an enterprise's financial statements and also provides guidance on measurement, derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006, but earlier adoption is permitted. The Company will adopt FIN 48 no later than October 1, 2007. The Company is currently assessing the impact the adoption of FIN 48 will have on its financial position and results of operations.

In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections, which replaces APB Opinion No. 20, Accounting Changes, and SFAS No. 3, Reporting Accounting Changes in Interim Financial Statements. SFAS No. 154 applies to all voluntary changes in accounting principles and requires retrospective application (a term defined by the statement) to prior periods' financial statements, unless it is impracticable to determine the effect of a change. It also applies to changes required by an accounting pronouncement that does not include specific transition provisions. SFAS No. 154 is effective for fiscal years beginning after December 15, 2005. The Company will adopt SFAS No. 154 on October 1, 2006 and does not expect that the adoption will have a material impact on its financial position or results of operations.

In February 2006, the FASB issued SFAS No. 155, Accounting for Certain Hybrid Financial Instruments—an amendment of FASB Statements No. 133 and 140. SFAS No. 155 permits fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation, clarifies which interest-only strips and principal-only strips are not subject to the requirements of SFAS No. 133, establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation, clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives, and amends SFAS No. 140 to

eliminate the prohibition on a qualifying special-purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument. SFAS No. 155 is effective for all financial instruments acquired or issued after the beginning of an entity's first fiscal year that begins after September 15, 2006. The Company will adopt SFAS No. 155 on October 1, 2006 and does not expect that the adoption will have a material impact on its financial position or results of operations.

**Reclassification** The Company has reclassified \$16.9 million of restructuring accruals, principally consisting of future rental commitments under operating leases, from current liabilities to other long-term liabilities on its September 30, 2005 balance sheet to conform to the current period presentation. This reclassification did not affect the Company's results of operations or cash flows for the year ended September 30, 2005 and did not affect total assets, total liabilities or total shareholders' equity as of September 30, 2005. Additionally, this reclassification did not have a material impact on current or long-term liabilities as of September 30, 2005. The remaining current

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portion of the restructuring liability of \$11.9 million as of September 30, 2005 has been included in other current liabilities on the accompanying condensed consolidated balance sheet.

**2. Business Combination*****Paxonet Communications, Inc.***

In December 2004, the Company acquired all of the outstanding capital stock of Paxonet Communications, Inc., a privately-held company headquartered in Fremont, California, with an engineering workforce primarily based in India. This acquisition was accounted for using the purchase method of accounting in accordance with SFAS No. 141,

Business Combinations. The Company's statements of operations include the results of Paxonet from the date of acquisition.

The aggregate purchase price for this acquisition was \$14.8 million. Of this purchase price, approximately \$0.3 million was allocated to net tangible assets, approximately \$0.7 million was allocated to unearned compensation representing the intrinsic value of unvested stock options exchanged in the transaction, approximately \$1.4 million was allocated to identifiable intangible assets, and the remaining \$12.4 million was allocated to goodwill. The identifiable intangible assets are being amortized on a straight-line basis over their useful lives of between two and eight years, with a weighted-average life of approximately six years. The pro forma effect of this acquisition was not material to the Company's results of operations for the nine months ended June 30, 2005.

**3. Supplemental Financial Information*****Marketable Securities***

Available-for-sale securities classified as current assets consist of the following (in thousands):

	<b>Cost or Amortized Cost</b>	<b>Gross Unrealized Holding Gains</b>	<b>Gross Unrealized Holding Losses</b>	<b>Fair Value</b>
<b>June 30, 2006:</b>				
Corporate debt securities	\$ 26,506	\$	\$ (192)	\$ 26,314
U.S. government agency securities	80,042		(64)	79,978
Equity securities	34,068			34,068
	\$ 140,616	\$	\$ (256)	\$ 140,360
<b>September 30, 2005:</b>				
Corporate debt securities	\$ 37,974	\$	\$ (40)	\$ 37,934
U.S. government agency securities	58,137	2	(171)	57,968
Equity securities	52,524		(9,120)	43,404
	\$ 148,635	\$ 2	\$ (9,331)	\$ 139,306

Available-for-sale securities classified as non-current assets consist of the following (in thousands):

	<b>Cost or Amortized Cost</b>	<b>Gross Unrealized Holding Gains</b>	<b>Gross Unrealized Holding Losses</b>	<b>Fair Value</b>
<b>September 30, 2005:</b>				



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U.S. government agency securities	\$ 15,964	\$	\$ (102)	\$ 15,862
Corporate debt securities	22,910		(287)	22,623
	\$ 38,874	\$	\$ (389)	\$ 38,485

The Company's marketable equity securities at June 30, 2006 and September 30, 2005 consist of 6.2 million shares of Skyworks Solutions, Inc. common stock. The Company's weighted average cost basis in these shares was \$8.49 per share, and the market values at June 30, 2006 and September 30, 2005 were \$5.51 and \$7.02 per share, respectively. As of June 30, 2006, the market value of these securities has been less than the Company's cost basis for approximately one year. The Company has evaluated the near-term prospects of Skyworks in relation to the magnitude and duration of the impairment, as well as the Company's intent and ability to hold the shares for a

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reasonable period of time sufficient for a recovery of fair value. As a result of (i) a 19% decline in the fair value of the Skyworks shares between March 31, 2006 and June 30, 2006, (ii) the fact that the shares have now been trading below the Company's cost basis for approximately one year, and (iii) the fact that the Company can only reasonably hold these shares until its \$456.5 million principal amount of 4% convertible subordinated notes become due in February 2007, the Company considers these securities to be other-than-temporarily impaired at June 30, 2006. As a result, the Company has recorded an impairment charge of \$18.5 million in the accompanying condensed consolidated statements of operations for the three and nine months ended June 30, 2006. This impairment charge was recognized by reclassifying the unrealized loss that was included in accumulated other comprehensive income (loss) on the Company's balance sheet. This charge permanently reduced the Company's basis in the Skyworks shares to \$5.51 per share, which was the Skyworks closing share price on the Nasdaq Stock Market on June 30, 2006. Future changes in the fair value of the Skyworks shares will be recorded in accumulated other comprehensive income (loss) on the Company's balance sheet and will be subject to further other-than-temporary impairment reviews.

The Company also evaluated its U.S. government agency and corporate debt securities and determined that certain of these investments were other-than-temporarily impaired. As a result, the Company has recorded impairment charges of \$0.1 million and \$0.3 million in the accompanying condensed consolidated statements of operations for the three and nine months ended June 30, 2006, respectively.

**Inventories**

Inventories consist of the following (in thousands):

	<b>June 30, 2006</b>	<b>September 30, 2005</b>
Work-in-process	\$ 43,543	\$ 61,535
Finished goods	39,933	33,794
	<b>\$ 83,476</b>	<b>\$ 95,329</b>

At June 30, 2006 and September 30, 2005, inventories are net of excess and obsolete (E&O) inventory reserves of \$38.9 million and \$44.8 million, respectively. In addition, at June 30, 2006 and September 30, 2005, inventories are net of lower of cost or market (LCM) reserves of \$5.0 million and \$6.7 million, respectively.

**Goodwill**

The changes in the carrying amount of goodwill for the nine months ended June 30, 2006 was as follows (in thousands):

Goodwill at September 30, 2005	\$ 717,013
Additions	3,000
Adjustments	(8,368)
Goodwill at June 30, 2006	\$ 711,645

During the nine months ended June 30, 2006, the Company recorded \$3.0 million of additional goodwill related to an earn-out for a previous business combination. The Company also recorded an \$8.2 million reduction of goodwill during the nine months ended June 30, 2006 as a result of the adoption of SFAS No. 123(R) (see Note 1).

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**Intangible Assets**

Intangible assets consist of the following (in thousands):

	<b>June 30, 2006</b>			<b>September 30, 2005</b>		
	<b>Gross Carrying Amount</b>	<b>Accumulated Amortization</b>	<b>Book Value</b>	<b>Gross Carrying Amount</b>	<b>Accumulated Amortization</b>	<b>Book Value</b>
Developed technology	\$ 138,883	\$ (67,636)	\$ 71,247	\$ 146,146	\$ (54,133)	\$ 92,013
Customer base	4,660	(2,433)	2,227	4,660	(1,781)	2,879
Other intangible assets	15,724	(5,671)	10,053	21,888	(10,071)	11,817
	\$ 159,267	\$ (75,740)	\$ 83,527	\$ 172,694	\$ (65,985)	\$ 106,709

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</b>					
	<b>of 2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>Thereafter</b>
Amortization expense	\$ 7,521	\$ 29,801	\$ 29,333	\$ 13,831	\$ 2,079	\$ 962

**Mindspeed Warrant**

The Company has a warrant to purchase 30 million shares of Mindspeed Technologies, Inc. common stock at an exercise price of \$3.408 per share through June 2013. At June 30, 2006 and September 30, 2005, the market value of Mindspeed's common stock was \$2.41 per share. The Company accounts for the Mindspeed warrant as a derivative instrument, and changes in the fair value of the warrant are included in other expense (income), net each period. At June 30, 2006, the aggregate fair value of the Mindspeed warrant included on the accompanying condensed consolidated balance sheet was \$29.3 million. The warrant was valued using the Black-Scholes-Merton model with expected terms for portions of the warrant varying from 1 to 5 years, expected volatility of 77%, a weighted average risk-free interest rate of 5.2% and no dividend yield. The aggregate fair value of the warrant is reflected as a long-term asset on the accompanying condensed consolidated balance sheet because the Company does not intend to liquidate any portion of the warrant 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.

**Short-Term Debt**

On November 29, 2005, the Company established an accounts receivable financing facility whereby it will sell, from time to time, certain accounts receivable to Conexant USA, LLC, a special purpose entity which is a consolidated subsidiary of the Company. Concurrently, Conexant USA entered into an \$80.0 million revolving credit agreement with a bank which is secured by the assets of Conexant USA. This credit agreement has a term of 364 days, with 364-day renewal periods at the discretion of the bank. Conexant USA is required to maintain certain minimum amounts on deposit (restricted cash) with the bank during the term of the credit agreement. Borrowings under the credit agreement, which cannot exceed the lesser of \$80.0 million and 85% of the uncollected value of purchased accounts receivable that are eligible for coverage under an insurance policy for the receivables, will bear interest equal to the 7-day LIBOR plus 0.6%. Additionally, Conexant USA will pay a fee of 0.2% per annum for the unused portion of the line of credit. The credit agreement also requires the Company and its consolidated subsidiaries to maintain minimum levels of shareholders' equity and cash and cash equivalents. Further, any failure by the Company or by

Conexant USA, LLC to pay their respective debts as they become due would allow the bank to terminate the credit agreement and cause all borrowings under the credit agreement to immediately become due and payable. At June 30, 2006, Conexant USA had \$8.8 million of restricted cash and \$88.9 million of accounts receivable, both of which serve as collateral under the credit agreement. At June 30, 2006, Conexant USA had borrowed \$80.0 million under this credit agreement and was in compliance with all financial covenants.

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**Long-Term Debt**

In May 2006, the Company retired \$130.0 million principal amount of its 5.25% convertible subordinated notes and \$66.8 million principal amount of its 4.25% convertible subordinated notes as they became due. In March 2006, the Company purchased \$58.5 million principal amount of its 4.00% convertible subordinated notes due February 2007 at prevailing market prices, resulting in a gain on the extinguishment of debt of \$0.4 million, net of the write-off of associated deferred debt issuance costs of \$0.2 million. This gain is included in other expense (income), net in the accompanying condensed consolidated statements of operations for the nine months ended June 30, 2006.

In March 2006, the Company issued \$200.0 million principal amount of 4% convertible subordinated notes due March 2026 and, in May 2006, the initial purchaser of the notes exercised its option to purchase an additional \$50.0 million principal amount of the 4% convertible subordinated notes due March 2026. Total proceeds to the Company from these issuances, net of issuance costs, were \$243.6 million. The notes are general unsecured obligations of the Company. Interest on the notes is payable in arrears semiannually on each March 1 and September 1, beginning on September 1, 2006. The notes are convertible, at the option of the holder upon satisfaction of certain conditions, into shares of the Company's common stock at a conversion price of \$4.92 per share, subject to adjustment for certain events. Upon conversion, the Company has the right to deliver, in lieu of common stock, cash or a combination of cash and common stock. Beginning on March 1, 2011, the notes may be redeemed at the Company's option at a price equal to 100% of the principal amount, plus any accrued and unpaid interest. Holders may require the Company to repurchase, for cash, all or part of their notes on March 1, 2011, March 1, 2016 and March 1, 2021 at a price of 100% of the principal amount, plus any accrued and unpaid interest.

Long-term debt consists of the following (in thousands):

	<b>June 30, 2006</b>	<b>September 30, 2005</b>
5.25% convertible subordinated notes due May 2006 with a conversion price of \$22.26	\$	\$ 130,000
4.25% convertible subordinated notes due May 2006 with a conversion price of \$9.08		66,825
4.00% convertible subordinated notes due February 2007 with a conversion price of \$42.43	456,500	515,000
4.00% convertible subordinated notes due March 2026 with a conversion price of \$4.92	250,000	
Total	706,500	711,825
Less: current portion of long-term debt	(456,500)	(196,825)
Long-term debt	\$ 250,000	\$ 515,000

**Other Expense (Income), Net**

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

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>June 30, 2006</b>	<b>June 30, 2005</b>	<b>June 30, 2006</b>	<b>June 30, 2005</b>
Investment and interest income	\$ (4,518)	\$ (2,182)	\$ (14,415)	\$ (3,956)

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Decrease in fair value of the Mindspeed warrant	35,131	16,085	3,800	14,804
Impairment loss of Skyworks shares	18,456		18,456	
Losses of equity method investments	648	2,127	3,303	8,587
Realized gains on sales of equity securities		(31,198)	(4,414)	(42,310)
Other	190	(442)	(307)	(492)
	\$ 49,907	\$ (15,610)	\$ 6,423	\$ (23,367)

**4. Shareholders Equity**

The Company's authorized capital consists of 1,000,000,000 shares of common stock, par value \$0.01 per share, and 25,000,000 shares of preferred stock, without par value, of which 5,000,000 shares are designated as Series A junior participating preferred stock (the Junior Preferred Stock).

The Company has a preferred share purchase rights plan to protect shareholders' rights in the event of a proposed takeover of the Company. A preferred share purchase right (a Right) is attached to each share of common stock

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pursuant to which the holder may, in certain takeover-related circumstances, become entitled to purchase from the Company 1/200<sup>th</sup> of a share of Junior Preferred Stock at a price of \$300, subject to adjustment. Also, in certain takeover-related circumstances, each Right (other than those held by an acquiring person) will generally be exercisable for shares of the Company's common stock or stock of the acquiring person having a market value of twice the exercise price. In certain events, each Right may be exchanged by the Company for one share of common stock or 1/200<sup>th</sup> of a share of Junior Preferred Stock. The Rights expire on December 31, 2008, unless earlier exchanged or redeemed at a redemption price of \$0.01 per Right, subject to adjustment.

**Stock Option Plans**

The Company has stock option plans and long-term incentive plans under which employees and directors may be granted options to purchase shares of the Company's common stock. As of June 30, 2006, approximately 53.7 million shares are available for grant under the stock option and long-term incentive plans. Stock options are generally granted with exercise prices of not less than the fair market value at grant date, generally vest over four years and expire eight or ten years after the grant date. The Company settles stock option exercises with newly issued shares of common stock. The Company has also assumed stock option plans in connection with business combinations.

A summary of activity under all of the Company's stock option plans is as follows:

	Shares (in thousands)	Weighted Average Exercise Price Per Share	Weighted Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value (in thousands)
Outstanding, September 30, 2005	111,195	\$ 2.81		
Granted	14,390	2.72		
Exercised	(7,130)	2.01		
Canceled	(11,470)	4.10		
Outstanding, June 30, 2006	106,985	2.71	4.75	\$ 39,159
Exercisable, June 30, 2006	74,078	\$ 2.97	3.72	\$ 20,910

The weighted average grant-date fair value of options granted during the nine months ended June 30, 2006 was \$1.78 per share. The total intrinsic value of options exercised during the nine months ended June 30, 2006 was \$8.4 million. The total cash received from employees as a result of stock option exercises was \$14.0 million for the nine months ended June 30, 2006.

At June 30, 2006, the total unrecognized fair value compensation cost related to unvested stock options and employee stock purchase plan awards was \$41.9 million, which is expected to be recognized over a remaining weighted average period of approximately 2.5 years.

**Directors Stock Plan**

The Company has a Directors Stock Plan which provides for each non-employee director to receive specified levels of stock option grants upon election to the Board of Directors and periodically thereafter. Under the Directors Stock Plan, each non-employee director may elect to receive all or a portion of the cash retainer to which the director is entitled through the issuance of common stock. During the nine months ended June 30, 2006, 80,000 stock options were granted under the Directors Stock Plan.

**Employee Stock Purchase Plan**

The Company has an Employee Stock Purchase Plan (ESPP) which allows eligible employees to purchase shares of the Company's common stock at a price equal to 85% of the lower of fair market value at the beginning or end of each offering period. Under the ESPP, employees may authorize the Company to withhold up to 15% of their compensation for each pay period to purchase shares under the plan, subject to certain limitations, and employees



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are limited to the purchase of 2,000 shares per offering period. Offering periods generally commence on the first trading day of February and August of each year and are generally six months in duration, but may be terminated earlier under certain circumstances. During the nine months ended June 30, 2006, approximately 1.9 million shares were issued under the ESPP for total proceeds of \$3.1 million.

At June 30, 2006, approximately 25.5 million shares of the Company's common stock were reserved for future issuance under the ESPP, of which 17.5 million shares become available in 2.5 million share annual increases, subject to the Board of Directors selecting a lower amount.

**Performance Share Plan**

The Company has a Performance Share Plan. On November 2, 2005, the Company issued performance shares at a fair value of \$2.16 per share to an executive in satisfaction of his fiscal 2005 performance share award granted under his employment agreement. The total fair value of the award was \$0.6 million and was paid with 154,879 shares of common stock and cash. At June 30, 2006, approximately 3.0 million shares of the Company's common stock are available for issuance under this plan, excluding approximately 0.3 million shares reserved for issuance under an executive's performance award granted in February 2006.

**5. Commitments and Contingencies****Lease Commitments**

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. Rental expense under operating leases was approximately \$11.9 million and \$17.0 million for the nine months ended June 30, 2006 and 2005, respectively.

At June 30, 2006, future minimum lease obligations, net of sublease income, under non-cancelable operating leases were as follows (in thousands):

<b>Fiscal Year</b>	<b>Lease Payments</b>	<b>Sublease Income</b>	<b>Net Obligation</b>
Remainder of 2006	\$ 8,353	\$ (1,978)	\$ 6,375
2007	29,963	(8,081)	21,882
2008	24,232	(6,753)	17,479
2009	16,485	(3,096)	13,389
2010	16,073	(3,125)	12,948
Thereafter	77,530	(8,862)	68,668
Total future minimum lease payments	\$ 172,636	\$ (31,895)	\$ 140,741

The summary of future minimum lease payments includes an aggregate gross amount of \$60.2 million of lease obligations that principally expire through fiscal 2021, which have been accrued for in connection with the Company's reorganization and restructuring actions (see Note 7) and previous actions taken by GlobespanVirata, Inc. prior to its merger with the Company in February 2004.

At June 30, 2006, the Company is contingently liable for approximately \$5.5 million in operating lease commitments on facility leases that were assigned to Mindspeed Technologies, Inc. and Skyworks Solutions, Inc. at the time of their separation from the Company.

**Legal Matters**

Certain claims have been asserted against the Company, including claims alleging the use of the intellectual property rights of others in certain of the Company's products. The resolution of these matters may entail the negotiation of a license agreement, a settlement, or the adjudication of such claims through arbitration or litigation. The outcome of litigation cannot be predicted with certainty and some lawsuits, claims or proceedings may be disposed of unfavorably.

for 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

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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 Company's financial condition, results of operations, or cash flows.

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

***Texas Instruments, Inc.*** The Company's Conexant, Inc. subsidiary (formerly named GlobespanVirata, Inc.) was involved in a dispute with Texas Instruments, Inc., Stanford University and its Board of Trustees, and Stanford University OTL, LLC (collectively, Texas Instruments or TI) over a group of patents (and related foreign patents) that Texas Instruments alleged are essential to certain industry standards for implementing ADSL technology. Globespan commenced the litigation against TI in the spring of 2003, alleging that TI had violated the antitrust laws and had engaged in patent misuse with respect to their licensing of patents related to Asymmetric Digital Subscriber Line (ADSL) technology, and furthermore that TI had violated the antitrust laws by suppressing competition in ADSL technology (the Antitrust and Patent Misuse Claims). Globespan also alleged various violations of state law, including breach of contract, breach of the implied covenant of good faith and fair dealing, promissory estoppel, and tortious interference with prospective economic advantage (the State Law Claims). TI brought counterclaims against Globespan, alleging that it had infringed certain TI patents and owed money damages for that infringement. Among other defenses to those claims of patent infringement, Globespan asserted that the patents were unenforceable because of patent misuse and furthermore that it was licensed to these patents under a license agreement between Conexant and TI, as of the date that Globespan merged into Conexant.

In the litigation, the District Court in New Jersey previously bifurcated the Antitrust and Patent Misuse Claims and the State Law Claims brought by Globespan and the patent counterclaims brought by TI, and directed that the patent issues asserted by TI would be tried first, with the antitrust and patent misuse claims asserted by Globespan to be tried second. Trial of the patent issues was conducted during January 2006 and into early February 2006. On February 6, 2006, the jury rendered a verdict finding that Globespan had infringed three patents and that its infringement was willful. The jury awarded lost profits damages to TI of \$60.5 million and reasonable royalty damages to TI of \$51.5 million, for a total verdict of \$112.0 million. As an alternative to the \$112.0 million verdict, the jury was also instructed to provide a damages award through March 1, 2004 (roughly the effective date for Globespan's argument

that it was licensed under the Conexant-TI license agreement). For the period through March 1, 2004, the jury awarded lost profits damages to TI of \$52.0 million and reasonable royalty damages of \$45.0 million for a total of \$97.0 million. TI also sought an award of prejudgment interest on any damages finally awarded.

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At the conclusion of the patent infringement phase of the trial, the district judge declined to enter a judgment with respect to this jury verdict. This was because a second phase of this case remained to be tried – the Antitrust and Patent Misuse Claims and State Law Claims asserted by Globespan against TI. Trial of that second phase was scheduled for October 2006. Thus, at that stage, there was no enforceable judgment against Globespan. If Globespan were to subsequently prevail on its Antitrust and Patent Misuse Claims in the subsequent phase of the litigation, the patent damages award to TI would have been barred in whole or in substantial part, and Globespan could have been entitled to the recovery of damages and attorneys' fees from TI if it had prevailed on its Antitrust and Patent Misuse Claims and/or its State Law Claims.

On March 3, 2006 the District Court issued an order granting TI's motion to dismiss certain of Globespan's antitrust claims. The court dismissed four counts of Globespan's complaint relating to certain defined ADSL markets. The court also dismissed Globespan's claims alleging that TI's patent licensing practices constituted per se unlawful tying under the antitrust laws.

On May 5, 2006, the Company announced that it had reached a definitive agreement with TI that settles all aspects of this dispute. Under the terms of the settlement agreement, the Company made a lump-sum payment of \$70.0 million to TI during the three months ended June 30, 2006 (see Note 7). The agreement resolves the alleged past infringement of ADSL patents by Globespan/Virata products and provides a fully paid-up, going-forward license for these products under a previously existing 2003 agreement between the Company and TI. In addition, the Company's patent license with TI was amended to make it clear that the previous agreement extends to all xDSL products.

**Class Action Suits** In December 2004 and January 2005, the Company and certain current and former officers and directors were named as defendants in several complaints seeking monetary damages filed on behalf of all persons who purchased Company common stock during a specified class period. These suits were filed in the U.S. District Court of New Jersey (New Jersey cases) and the U.S. District Court for the Central District of California (California cases), alleging that the defendants violated the Securities Exchange Act of 1934 by allegedly disseminating materially false and misleading statements and/or concealing material adverse facts. The California cases were consolidated with the New Jersey cases so that all of the class action suits, now known as *Witriol v. Conexant, et al.* (*Witriol*), are being heard in the U.S. District Court of New Jersey by the same judge. The defendants believe these charges are without merit and intend to vigorously defend the litigation. On September 1, 2005, the defendants filed their motion to dismiss the case. On November 23, 2005, the court granted the plaintiff's motion to file a second amended complaint, which was filed on December 5, 2005. The defendants filed an amended motion to dismiss the case on February 6, 2006. Plaintiffs filed their opposition on April 24, 2006, and defendant's reply was filed on June 14, 2006.

In addition, in February 2005, the Company and certain of its current and former officers and the Company's Employee Benefits Plan Committee were named as defendants in *Graden v. Conexant, et al.*, a lawsuit filed on behalf of all persons who were participants in the Company's 401(k) Plan (Plan) during a specified class period. This suit was filed in the U.S. District Court of New Jersey and alleges that the defendants breached their fiduciary duties under the Employee Retirement Income Security Act, as amended, to the Plan and the participants in the Plan. The plaintiff filed an amended complaint on August 11, 2005. On October 12, 2005, the defendants filed a motion to dismiss this case. The plaintiff responded to the motion to dismiss on December 30, 2005, and the defendants' reply was filed on February 17, 2006. On March 31, 2006, the judge dismissed this case and ordered it closed. Plaintiff filed a notice of appeal on April 17, 2006.

**Shareholder Derivative Suits** In January 2005, the Company and certain current and former directors and officers were named as defendants in purported shareholder derivative actions seeking monetary damages (now consolidated) in the California Superior Court for the County of Orange, alleging that the defendants breached their fiduciary duties, abused control, mismanaged the Company, wasted corporate assets and unjustly enriched themselves. A similar lawsuit was filed in the U.S. District Court of New Jersey in May 2005. On July 28, 2005, the California court approved a stay of the actions filed in California pending the outcome of the motion to dismiss in the *Witriol* case. The

Company has negotiated a similar stay agreement with the plaintiffs in the New Jersey case, which has also been approved by the New Jersey court. Pursuant to the stay agreements, in the event that the parties

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in the *Witriol* case engage in any negotiations, plaintiffs' counsel in the derivative cases will be kept informed. The defendants believe the charges in these cases are without merit and intend to vigorously defend the litigation.

**Guarantees and Indemnifications**

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

In connection with the Company's acquisition of Amphion Semiconductor in June 2004, the Company guaranteed the value of the 600,000 shares issued to the former Amphion shareholders for a defined period through June 29, 2006 (subject to certain conditions and elections). The guaranty was subject to adjustment for any stock split, stock dividend, recapitalization, merger or similar transaction. In the event that the market price of the Company's common stock did not equal or exceed \$10.00 for at least five consecutive trading days during this period, the Company would be required to make an additional payment to former Amphion shareholders for the difference between the \$10.00 and the market price per share of such shares as of specified dates. Based on the Company's average closing stock price on the five days prior to June 29, 2006, the Company recorded a \$4.6 million charge to additional paid-in capital related to this guaranty as of June 30, 2006, which was paid in July 2006.

**Other**

The Company has been designated as a potentially responsible party and is engaged in groundwater remediation at one Superfund site located at a former silicon wafer manufacturing facility and steel fabrication plant in Parker Ford, Pennsylvania formerly occupied by the Company. In addition, the Company is engaged in remediation of groundwater contamination at its former Newport Beach, California wafer fabrication facility. Management currently estimates the aggregate remaining costs for these remediations to be approximately \$2.3 million and has accruals for these costs in the accompanying condensed consolidated balance sheets.

In connection with certain non-marketable equity investments, with a carrying value of \$7.4 million, the Company may be required to invest up to an additional \$4.9 million as of June 30, 2006. These additional investments are subject to capital calls, and a decision by the Company not to participate could result in an impairment of the existing investments.

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**6. Comprehensive Income (Loss)**

Comprehensive income (loss) consists of the following (in thousands):

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>June 30, 2006</b>	<b>June 30, 2005</b>	<b>June 30, 2006</b>	<b>June 30, 2005</b>
Net loss	\$ (67,090)	\$ (32,166)	\$ (101,493)	\$ (226,071)
Other comprehensive income (loss):				
Foreign currency translation adjustments	(226)	(481)	(933)	398
Unrealized gains on cash flow hedge contracts	82		82	
Unrealized gains (losses) on available-for-sale securities	(7,703)	29,387	(8,994)	(13,964)
Reclassification adjustment for realized losses (gains) on available-for-sale securities	18,456	(26,987)	18,456	(38,247)
Minimum pension liability adjustments	80	69	232	207
Other comprehensive income (loss)	10,689	1,988	8,843	(51,606)
Comprehensive loss	\$ (56,401)	\$ (30,178)	\$ (92,650)	\$ (277,677)

Accumulated other comprehensive loss consists of the following (in thousands):

	<b>June 30, 2006</b>	<b>September 30, 2005</b>
Foreign currency translation adjustments	\$ (4,353)	\$ (3,420)
Unrealized gains on cash flow hedge contracts	82	
Unrealized losses on available-for-sale securities	(256)	(9,718)
Minimum pension liability adjustments	(8,642)	(8,874)
Accumulated other comprehensive loss	\$ (13,169)	\$ (22,012)

**7. Special Charges**

Special charges (credits) consist of the following (in thousands):

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>June 30, 2006</b>	<b>June 30, 2005</b>	<b>June 30, 2006</b>	<b>June 30, 2005</b>
Litigation charge	\$ 30,000	\$	\$ 70,000	\$
Restructuring charges	2,610	6,731	2,394	24,470
Integration charges (credits)		1,649	(400)	6,760
Asset impairments		29	85	3,492
Other special charges			300	6,540
	\$ 32,610	\$ 8,409	\$ 72,379	\$ 41,262



***Litigation Charge***

Based on the Company's evaluation of the facts and circumstances regarding its patent litigation with Texas Instruments, the Company recorded a \$40.0 million charge during the three months ended March 31, 2006 related to this matter in accordance with SFAS No. 5, Accounting for Contingencies, and related interpretations, which was included in special charges in the Company's condensed consolidated statements of operations. On May 5, 2006, the Company announced that it had reached a definitive agreement with TI that settled all aspects of this dispute. Under the terms of the settlement agreement, the Company made a lump-sum payment of \$70.0 million to TI during the three months ended June 30, 2006. The \$30.0 million difference between the settlement amount and the amount accrued as of March 31, 2006 was recorded as an additional special charge during the three months ended June 30, 2006, for a total charge of \$70.0 million during the nine months ended June 30, 2006. For further information regarding the litigation with TI, see Note 5.

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**Restructuring Charges**

The Company has implemented a number of cost reduction initiatives since late fiscal 2001 to improve its operating cost structure. The cost reduction initiatives included workforce reductions and the closure or consolidation of certain facilities, among other actions. The costs and expenses associated with the restructuring activities, except for the liabilities associated with the 2004 Merger Related Reorganization Plan (described below) that related to the employees and facilities of GlobespanVirata, are included in special charges in the Company's consolidated statements of operations. The costs and expenses that relate to the employees and facilities of GlobespanVirata have been recorded as acquired liabilities in the merger and included as part of the purchase price allocation in accordance with EITF Issue No. 95-3, Recognition of Liabilities in Connection with a Business Combination, and SFAS No. 141, Business Combinations. In May 2004, the GlobespanVirata subsidiary was renamed Conexant, Inc.

*2006 Restructuring Action* In April 2006 and November 2005, the Company announced operating site closures and workforce reductions. In total, the Company has notified approximately 130 employees of their involuntary termination. During the nine months ended June 30, 2006, the Company recorded total charges of \$3.4 million based on the estimates of the cost of severance benefits for the affected employees and the estimated relocation benefits for those employees who have been offered and have commenced the relocation process. Additionally, the Company has recorded charges of \$0.4 million relating to the consolidation of certain facilities under non-cancelable leases which were vacated. The facility charges were determined in accordance with the provisions of SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities. As a result, the Company recorded the present value of the future lease obligations, in excess of the expected future sublease income, using a discount rate of 8.0%, and will accrete the remaining amounts into expense over the remaining term of the lease.

Activity and liability balances recorded as part of the 2006 Restructuring Action for the nine months ended June 30, 2006 were as follows (in thousands):

	<b>Workforce Reductions</b>	<b>Facility and Other</b>	<b>Total</b>
	\$	\$	\$
Restructuring balance, September 30, 2005			
Charged to costs and expenses	278		278
Cash payments	(5)		(5)
Restructuring balance, December 31, 2005	273		273
Charged to costs and expenses	1,220		1,220
Cash payments	(227)		(227)
Restructuring balance, March 31, 2006	1,266		1,266
Charged to costs and expenses	1,925	373	2,298
Cash payments	(1,386)	(23)	(1,409)
Restructuring balance, June 30, 2006	\$ 1,805	\$ 350	\$ 2,155

*2005 Restructuring Action* In November 2004, the Company announced plans to further reduce its operating expense level by the end of 2005. The components of this plan were a shift of product development resources to lower-cost regions and cost savings from continued merger-related sales, general and administrative consolidation. During fiscal year 2005, the Company announced several operating site closures and workforce reductions. In total, the Company notified approximately 255 employees of their involuntary termination, including approximately 175 domestic and 80 international employees. The Company recorded charges of \$19.7 million based on the estimates of the cost of

severance benefits for the affected employees and the estimated relocation benefits for those employees who have been offered and have commenced the relocation process. Additionally, the Company has recorded charges of \$7.2 million relating to the consolidation of certain facilities under non-cancelable leases which were vacated. The facility charges were determined in accordance with the provisions of SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities. As a result, the Company recorded the present value of the future lease obligations, in excess of the expected future sublease income, using a discount rate of 8.0%, and will accrete the remaining approximate \$8.1 million into expense over the remaining terms of the leases. The non-cash facility accruals include \$7.0 million of reclassifications of the deferred gains on the previous sale-leaseback of two facilities and \$6.6 million of reclassifications from earlier restructuring actions for another facility. During the nine months ended June 30, 2006, the Company increased its facilities related charges by \$1.0 million as

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a result of the accretion of rent expense and recorded a \$2.5 million net reduction of workforce related charges primarily due to a revised estimate of the remaining severance and termination benefits costs to be paid. Activity and liability balances recorded as part of the 2005 Restructuring Action for the nine months ended June 30, 2006 were as follows (in thousands):

	<b>Workforce Reductions</b>	<b>Facility and Other</b>	<b>Total</b>
Restructuring balance, September 30, 2005	\$ 3,544	\$ 19,338	\$ 22,882
Charged to costs and expenses	191	346	537
Reclassification to accrued compensation and benefits	1,899		1,899
Cash payments	(1,626)	(1,675)	(3,301)
Restructuring balance, December 31, 2005	4,008	18,009	22,017
Charged (credited) to costs and expenses	(2,720)	321	(2,399)
Reclassifications	(55)	55	
Cash payments	(561)	(1,070)	(1,631)
Restructuring balance, March 31, 2006	672	17,315	17,987
Charged to costs and expenses		302	302
Cash payments	(155)	(1,281)	(1,436)
Restructuring balance, June 30, 2006	\$ 517	\$ 16,336	\$ 16,853

*2004 Restructuring Actions* The Company approved several restructuring plans during fiscal 2004. In connection with its merger with GlobespanVirata, the Company began to formulate a plan which included workforce reductions and facility consolidation actions. This plan was communicated at the time of the merger and has been completed (the 2004 Merger Related Restructuring and Reorganization Plans). During the fourth fiscal quarter of 2004, the Company announced additional workforce reduction and facility consolidation actions in response to lower than anticipated revenue levels.

In connection with its merger with GlobespanVirata, the Company began to formulate the 2004 Merger Related Reorganization Plan which consisted primarily of workforce reductions to eliminate redundant positions and consolidation of worldwide facilities. The portions of the plan that pertained to Conexant, Inc. employees and facilities were recorded as acquired liabilities in the merger and included as part of the purchase price allocation, in accordance with EITF Issue No. 95-3 and SFAS No. 141. This plan consisted of an involuntary workforce reduction which affected approximately 35 employees of Conexant, Inc. These employees were located in the United States in sales and administrative functions. The charge associated with these workforce reductions of approximately \$1.3 million was based upon estimates of the severance and fringe benefits for the affected employees, in addition to relocation benefits for others. The facility consolidation plan resulted in an initial charge of \$13.5 million and included assumptions regarding sublease rates and time periods and other costs to prepare and sublease the applicable spaces. Additionally, at the date of the merger, there had been a decline in the real estate market in certain geographic regions in which Conexant, Inc. had leased facilities. A portion of the facilities related charges represent adjustments to the fair market value rates of those leases. These non-cancelable lease commitments range from near term to 17 years in length. In fiscal 2004, the Company reduced the original facility consolidation charge by approximately \$3.6 million and increased the workforce related charge by approximately \$0.2 million as a result of finalizing the 2004 Merger Related Reorganization Plan and recorded these changes as adjustments to the purchase price allocation (goodwill). In fiscal 2005, as a result of finalizing facilities consolidation actions, the Company reduced its facilities reserves by a

total of \$1.2 million as adjustments to the purchase price allocation (goodwill). Additionally, in fiscal 2005, as a result of the final closure of a facility in Europe, \$3.7 million of reserves were transferred from the 2004 Merger Related Reorganization Plan to the 2005 Restructuring Action.

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Activity and liability balances recorded as part of the 2004 Merger Related Reorganization Plan pertaining to Conexant, Inc. employees and facilities for the nine months ended June 30, 2006 were as follows (in thousands):

	<b>Workforce Reductions</b>	<b>Facility and Other</b>	<b>Total</b>
Restructuring balance, September 30, 2005	\$	\$ 3,345	\$ 3,345
Credited to costs and expenses		(55)	(55)
Cash payments		(141)	(141)
Restructuring balance, December 31, 2005		3,149	3,149
Cash payments		(154)	(154)
Restructuring balance, March 31, 2006		2,995	2,995
Cash payments		(154)	(154)
Restructuring balance, June 30, 2006	\$	\$ 2,841	\$ 2,841

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

During the fourth fiscal quarter of 2004, the Company announced additional workforce reduction actions in response to lower than anticipated revenue levels. The Company recorded an additional \$5.1 million (for a total of \$7.0 million in fiscal 2004) based on the estimates of the cost of severance benefits for the affected employees. An additional \$1.5 million of net severance benefits was earned in fiscal 2005 based on the passage of time in the notification period, net of resignations and favorable adjustments of final settlement amounts. In total, the Company notified approximately 230 employees of their involuntary termination, including approximately 180 domestic and 50 international employees. The workforce reductions affected employees in all areas of the business and are complete. Activity and liability balances recorded as part of the 2004 Merger Related Restructuring Plan pertaining to Conexant Systems, Inc. employees and facilities and the additional fourth fiscal quarter of 2004 restructuring action for the nine months ended June 30, 2006 were as follows (in thousands):

	<b>Workforce Reductions</b>	<b>Facility and Other</b>	<b>Total</b>
Restructuring balance, September 30, 2005	\$ 65	\$ 831	\$ 896
Charged to costs and expenses	170		170
Cash payments	(224)	(183)	(407)
Restructuring balance, December 31, 2005	11	648	659
Charged to costs and expenses	33		33
Cash payments	(42)	(167)	(209)

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Restructuring balance, March 31, 2006	2	481	483
Charged to costs and expenses	10		10
Cash payments	(10)	(174)	(184)
Restructuring balance, June 30, 2006	\$ 2	\$ 307	\$ 309

*2003 Corporate Restructuring Plan* In the fourth quarter of fiscal 2003, the Company initiated a workforce reduction, closed a design center and consolidated some facilities. The Company involuntarily terminated employees in the sales and administration areas and recorded charges aggregating \$1.2 million based upon estimates of the cost of severance benefits for the affected employees. The Company also recorded restructuring costs of \$2.8 million relating to the consolidation of certain facilities under non-cancelable leases which were vacated. In fiscal 2005, as a result of favorable sublease experience, the Company reduced its facilities reserve by \$1.0 million.

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Activity and liability balances related to the 2003 Corporate Restructuring Plan for the nine months ended June 30, 2006 were as follows (in thousands):

	<b>Workforce Reductions</b>	<b>Facility and Other</b>	<b>Total</b>
Restructuring balance, September 30, 2005	\$	\$ 716	\$ 716
Cash payments		(144)	(144)
Restructuring balance, December 31, 2005		572	572
Cash payments		(143)	(143)
Restructuring balance, March 31, 2006		429	429
Cash payments		(171)	(171)
Restructuring balance, June 30, 2006	\$	\$ 258	\$ 258

*2002 Corporate and Manufacturing Restructuring Plan* During fiscal 2002, the Company initiated a reduction of its workforce throughout its operations primarily as a result of the divestiture of its Newport Beach wafer fabrication operations and the spin-off and merger of its wireless communications business with Alpha Industries, Inc. to form Skyworks Solutions, Inc. 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. 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. In fiscal 2005, as a result of unfavorable sublease experience, the Company increased its facilities reserve by \$0.6 million.

Activity and liability balances related to the 2002 Corporate and Manufacturing Restructuring Plan for the nine months ended June 30, 2006 were as follows (in thousands):

	<b>Workforce Reductions</b>	<b>Facility and Other</b>	<b>Total</b>
Restructuring balance, September 30, 2005	\$	\$ 990	\$ 990
Cash payments		(489)	(489)
Restructuring balance, December 31, 2005		501	501
Cash payments		(183)	(183)



Restructuring balance, March 31, 2006			318	318
Cash payments			(83)	(83)
Restructuring balance, June 30, 2006	\$	\$	235	\$ 235

Through June 30, 2006, the Company has paid an aggregate of \$75.4 million in connection with all of its restructuring plans and has remaining restructuring accruals of \$22.7 million, of which \$2.3 million relates to workforce reductions and \$20.4 million relates to facility and other costs. Of the \$22.7 million of restructuring accruals at June 30, 2006, \$7.7 million is included in other current liabilities and \$15.0 million is included in other liabilities in the accompanying condensed consolidated balance sheet as of June 30, 2006. The Company expects to pay the amounts accrued for the workforce reductions through fiscal 2007 and expects to pay the obligations for the non-cancelable lease and other commitments over their respective terms, which expire at various times through fiscal 2021. Cash payments to complete the restructuring actions will be funded from available cash reserves and funds from product sales, and are not expected to significantly impact the Company's liquidity.

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***Integration Charges (Credits)***

The integration credit of \$0.4 million in the nine months ended June 30, 2006 resulted from a true-up of previously accrued retention bonus amounts for individuals who left the Company prior to earning the benefit.

Integration charges of \$1.6 million and \$6.8 million in the three and nine months ended June 30, 2005, respectively, consisted of costs committed as a result of the integration efforts of the employees, customers, operations and other business aspects related to the merger with GlobespanVirata.

***Asset Impairments***

During the nine months ended June 30, 2006, the Company recorded asset impairment charges of \$0.1 million related to prior facility closures.

During the nine months ended June 30, 2005, the Company recorded asset impairment charges of \$3.5 million related to various operating assets which were determined to be redundant and no longer required as a result of restructuring activities. These assets have been abandoned.

***Other Special Charges***

During the nine months ended June 30, 2006, the Company recorded other special charges of \$0.3 million related to prior facility closures. Other special charges of \$6.5 million in the nine months ended June 30, 2005 consisted of \$3.2 for the settlement of legal matters, \$2.3 million of stock option and warrant modification charges, and \$1.0 million of other special charges.

**8. Segment and Geographic Information**

SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information, establishes standards for the way that public business enterprises report information about operating segments in annual consolidated financial statements. Although the Company had four operating segments at June 30, 2006, under the aggregation criteria set forth in SFAS No. 131, it only operates in one reportable operating segment, broadband communications.

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

the nature of products and services;

the nature of the production processes;

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

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

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

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

the products sold by each of the Company's operating segments use the same standard manufacturing process;

the products marketed by each of the Company's operating segments are sold to similar customers; and

all of the Company's products are sold through its internal sales force and common distributors.

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

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

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

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>June 30, 2006</b>	<b>June 30, 2005</b>	<b>June 30, 2006</b>	<b>June 30, 2005</b>
Americas	\$ 32,346	\$ 24,490	\$ 75,405	\$ 64,196
Asia-Pacific	196,627	160,989	596,723	399,046
Europe, Middle East and Africa	22,662	11,985	52,796	44,581
	<b>\$ 251,635</b>	<b>\$ 197,464</b>	<b>\$ 724,924</b>	<b>\$ 507,823</b>

The Company believes a portion of the products sold to original equipment manufacturers (OEMs) and third-party manufacturing service providers in the Asia-Pacific region are ultimately shipped to end-markets in the Americas and Europe. For the three months ended June 30, 2005 and the nine months ended June 30, 2006 and 2005, no customer accounted for 10% or more of net revenues. There was one customer that accounted for 10% of net revenues for the three months ended June 30, 2006. Sales to the Company's twenty largest customers represented approximately 66% and 65% of net revenues for the nine months ended June 30, 2006 and 2005, respectively.

Long-lived assets consist of property, plant and equipment and certain other long-term assets. Long-lived assets by geographic area were as follows (in thousands):

	<b>June 30, 2006</b>	<b>September 30, 2005</b>
Americas	\$ 89,725	\$ 76,270
Asia-Pacific	14,781	6,845
Europe, Middle East and Africa	2,158	2,702
	<b>\$ 106,664</b>	<b>\$ 85,817</b>

**9. Related Party Transactions****Jazz Semiconductor, Inc.**

As of June 30, 2006, the Company has an ownership interest in Jazz Semiconductor, Inc. of approximately 42% (after giving effect to the transactions described below). In addition, two members of the Company's Board of Directors, including its Chairman and Chief Executive Officer, also serve on the Board of Jazz. At June 30, 2006 and September 30, 2005, the Company had net payables to Jazz of \$7.7 million and \$9.4 million, respectively.

**Wafer and Probe Services Purchases** The Company entered into a five-year wafer supply and services agreement with Jazz in March 2002, under which it was provided with \$60.0 million of credits to be used during the third, fourth and fifth years of the agreement to offset any increase in the contract price for wafers purchased by the Company during those years. Through June 2006, the Company did not realize any of these credits because Jazz did not increase the contract price of wafers sold pursuant to the agreement. During the first three years of the wafer supply and services agreement, the Company was obligated to purchase a minimum volume of wafers and, in each year, it purchased more than the specified minimum volume. In addition, following the expiration of the agreement, the Company had the right to apply up to an aggregate of \$20.0 million of unused credits to wafer purchases, limited in amount to \$400 per wafer, regardless of price. Through June 2006, the Company had not accrued for any of these future credits, as they were neither probable nor reasonably estimable at that time. In June 2006, the Company and Jazz entered into a wafer supply termination agreement in which both parties agreed to terminate the wafer supply and

services agreement. In connection with the termination agreement, Jazz agreed to (i) issue 7,583,501 shares of their series B common stock to the Company and (ii) forgive \$1.2 million owed to Jazz by the Company for the reimbursement of property taxes previously paid by Jazz. The number of Jazz shares issued to the Company will be adjusted, up or down, if Jazz engages in a liquidity event prior to June 26, 2007 that values the price per share of their common stock at a price lower or higher, respectively, than \$2.16, such that the Company will have received shares with an aggregate value of \$16.3 million, based on the value of a share of common stock in the liquidity event. A liquidity event includes Jazz's issuance of equity securities for cash consideration in a public offering or a merger or similar transaction in which they undergo a change of control. As a result of the termination agreement, the Company is no longer entitled to use any wafer credits provided to it under the original agreement. The Company recognized a gain of \$17.5

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

million, which is included as a separate line item in cost of goods sold, during the three and nine months ended June 30, 2006 as a result of the termination agreement. The Company records its share of Jazz's net income (loss) one quarter in arrears. As such, the Company has not recorded its share of Jazz's expense related to the termination agreement in the accompanying condensed consolidated statements of operations for the three and nine months ended June 30, 2006. The Company will record its share of the Jazz's expense in the quarter following the quarter in which Jazz recognizes the expense in its statement of operations.

During the three months ended June 30, 2006 and 2005, the Company purchased wafers and probe services from Jazz totaling \$11.7 million and \$14.6 million, respectively. During the nine months ended June 30, 2006 and 2005, the Company purchased wafers and probe services from Jazz totaling \$40.9 million and \$37.6 million, respectively.

**Lease Agreement** The Company also leases a fabrication facility to Jazz. During the three months ended June 30, 2006 and 2005, rental income received from Jazz totaled \$0.7 million and \$0.8 million, respectively. During the nine months ended June 30, 2006 and 2005, rental income received from Jazz totaled \$2.1 million and \$3.0 million, respectively.

**Mindspeed Technologies, Inc.**

As of June 30, 2006, the Company holds a warrant to purchase 30 million shares of Mindspeed Technologies, Inc. common stock at an exercise price of \$3.408 per share through June 2013. In addition, three members of the Company's Board of Directors, including its Chairman and Chief Executive Officer, also serve on the Board of Mindspeed. At September 30, 2005, the Company had a net receivable from Mindspeed of \$0.2 million. No significant amounts were due to or receivable from Mindspeed at June 30, 2006.

**Lease Agreement** The Company leases an office building to Mindspeed. Under the lease agreement, Mindspeed pays amounts for rental expense and operating expenses, which include utilities, common area maintenance, and security services. During the three months ended June 30, 2006 and 2005, total payments from Mindspeed in relation to this lease were \$1.6 million and \$1.5 million, respectively, including payments of \$1.0 million and \$0.7 million, respectively that Mindspeed paid directly to the Company's landlord. During the nine months ended June 30, 2006 and 2005, total payments from Mindspeed were \$4.8 million and \$3.7 million, respectively, including payments of \$3.0 million and \$0.7 million, respectively that Mindspeed paid directly to the Company's landlord.

**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 condensed consolidated 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, 2005.

**Overview**

We design, develop and sell semiconductor system solutions for use in broadband communications, enterprise networks and digital home networks worldwide. Our expertise in mixed-signal processing, digital signal processing and standards-based communications protocol implementation allows us to deliver semiconductor devices and integrated systems for client, or end-customer, personal communications access products. These products include PCs and PC peripheral products, television set-top boxes, residential gateways, game consoles, point-of-sale (POS) terminals, multi-function peripherals (MFPs) and other types of consumer and enterprise products. These communications access end-products connect to audio, video, voice and data services over broadband wireline communications networks, including digital subscriber line (DSL), cable and Ethernet, over dial-up Internet connections, over wireless local area networks and over direct broadcast satellite, terrestrial and fixed wireless systems. We also design, develop and sell semiconductor system solutions used in telecommunications company central office equipment, primarily in DSL access multiplexers.

We organize our product lines to address four primary communications end-markets. First, our broadband access products include a comprehensive portfolio of DSL products designed for customer premises equipment and central office applications in addition to products designed for emerging passive optical network applications. Second, our broadband media processing products include a variety of broadcast audio and video decoder and encoder devices as well as front-end communications components that enable the capture, display, storage, playback and transfer of audio and video content in digital home and small office products such as PCs, television set-top boxes, gaming consoles, personal video recorders and digital versatile disk (DVD) applications. Third, our universal and voice access products include a broad portfolio of analog modem chipsets and software for desktop and notebook PC applications as well as embedded equipment applications, including fax machines, MFPs, POS terminals, television set-top boxes, gaming consoles and Internet terminals. This product area also includes our voice-over-Internet protocol (VoIP) products designed to accommodate the transmission of voice traffic within broadband IP packet-based networks. And fourth, our wireless networking products include various combinations of radio frequency transceivers, analog base-band integrated circuits, and digital base-band and medium or media access controller (MAC) chips that comply with the various configurations of the 802.11 wireless local area networking (WLAN) standard.

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 2006, as compared to 28% for the similar period of fiscal 2005. For the three months ended June 30, 2005 and the nine months ended June 30, 2006 and 2005, no customer accounted for 10% or more of net revenues. There was one customer that accounted for 10% of net revenues for the three months ended June 30, 2006. Our top 20 customers accounted for approximately 66% and 65% of net revenues for the first nine months of fiscal 2006 and 2005, respectively. Revenues derived from customers located in the Asia-Pacific region, the Americas, and Europe (including the Middle East and Africa) were 82%, 11%, and 7%, respectively, of our net revenues for the first nine months of fiscal 2006 and were 79%, 13%, and 8%, respectively, of our net revenues for the first nine months of fiscal 2005. We believe a portion of the products we sell to OEMs and third-party manufacturing service providers in the Asia-Pacific region are ultimately shipped to end-markets in the Americas and Europe.

**Table of Contents****Results of Operations****Net Revenues**

<i>(in thousands)</i>	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>June 30, 2006</b>	<b>June 30, 2005</b>	<b>June 30, 2006</b>	<b>June 30, 2005</b>
Net revenues	\$251,635	\$197,464	\$724,924	\$507,823

Net revenues increased 27% in the third quarter of fiscal 2006 compared to the third quarter of fiscal 2005. This increase was driven by a 22% increase in unit volume shipments. The unit volume shipments increased in the third quarter of fiscal 2006 compared to the third quarter of fiscal 2005 as a result of increased demand for our broadband media products as satellite set-top box design wins began to ramp into production and, to a lesser extent, for our broadband access central office products due to market share gains.

Net revenues increased 43% in the first nine months of fiscal 2006 compared to the first nine months of fiscal 2005. This increase was driven by a 46% increase in unit volume shipments, which more than offset a 2% decrease in ASPs. The unit volume shipments increased in the first nine months of fiscal 2006 compared to the first nine months of fiscal 2005 as a result of (i) the approximate \$60.0 million channel inventory reduction at our distributors and estimated \$10.0 million inventory reduction at our direct customers in the first nine months of fiscal 2005 (discussed below) and (ii) increased demand for our broadband media products as satellite set-top box design wins began to ramp into production and, to a lesser extent, for our broadband access central office products due to market share gains. During fiscal 2004, we experienced lower than expected end customer demand which resulted in excess channel inventory build up at our direct customers, distributors and resellers. During the first half of fiscal 2005, we reduced channel inventory at our distributors by approximately \$60.0 million, and we believe that there was an approximate \$10.0 million reduction of channel inventory at our direct customers.

**Gross Margin**

<i>(in thousands)</i>	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>June 30, 2006</b>	<b>June 30, 2005</b>	<b>June 30, 2006</b>	<b>June 30, 2005</b>
Gross margin	\$131,537	\$75,034	\$333,500	\$142,162
Percent of net revenues	52%	38%	46%	28%

Gross margin represents net revenues less cost of goods sold. As a fabless semiconductor company, we use third parties for wafer production and assembly and test services. Our cost of goods sold consists predominantly of purchased finished wafers, assembly and test services, royalties, amortization of production photo mask costs, other intellectual property costs, labor and overhead associated with product procurement, and non-cash stock-based compensation charges for procurement personnel.

Our gross margin percentage for the third quarter of fiscal 2006 was 52% compared with 38% for the third quarter of fiscal 2005. During the third quarter of fiscal 2006, we recorded a \$17.5 million gain related to the cancellation of a wafer supply and services agreement with Jazz Semiconductor, Inc., which was recorded as a reduction of cost of sales. Excluding this gain, the impact of changes to revenue reserves that we maintain to estimate customer pricing adjustments, and the impact of changes to our inventory reserves, our gross margin percentage for the third quarter of fiscal 2006 would have been 44%, compared to 39% for the third quarter of fiscal 2005. The higher gross margin percentage in the third quarter of fiscal 2006 can be attributed to the benefits of our product cost-reduction initiatives, as well as more stable product pricing.

Our gross margin percentage for the first nine months of fiscal 2006 was 46% compared with 28% for the first nine months of fiscal 2005. Excluding the \$17.5 million gain on the cancellation of the wafer supply and services agreement with Jazz, the impact of changes to revenue reserves that we maintain to estimate customer pricing adjustments, and the impact of changes to our inventory reserves, our gross margin percentage for the first nine

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months of fiscal 2006 would have been 43%, compared to 39% for the first nine months of fiscal 2005. The higher gross margin percentage in the first nine months of fiscal 2006 can be attributed to the benefits of our product cost-reduction initiatives, as well as more stable product pricing.

We assess the recoverability of our inventories on a quarterly basis through a review of inventory levels in relation to foreseeable demand, generally over the following twelve months. Foreseeable demand is based upon available information, including sales backlog and forecasts, product marketing plans and product life cycle information. When the inventory on hand exceeds the foreseeable demand, we write down the value of those inventories which, at the time of our review, we expect to be unable to sell. The amount of the inventory write-down is the excess of historical cost over estimated realizable value. Once established, these write-downs are considered permanent adjustments to the cost basis of the excess inventory. Demand for our products may fluctuate significantly over time, and actual demand and market conditions may be more or less favorable than those projected by management. In the event that actual demand is lower than originally projected, additional inventory write-downs may be required. Similarly, in the event that actual demand exceeds original projections, gross margins may be favorably impacted in future periods. During the three months ended June 30, 2006 and 2005, we recorded \$4.9 million and \$2.1 million, respectively, of inventory charges for excess and obsolete (E&O) inventory. During the nine months ended June 30, 2006 and 2005, we recorded \$12.1 million and \$31.3 million, respectively, of inventory charges for E&O inventory. Activity in our E&O inventory reserves for the three and nine months ended June 30, 2006 and 2005 was as follows:

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>June 30, 2006</b>	<b>June 30, 2005</b>	<b>June 30, 2006</b>	<b>June 30, 2005</b>
<i>(in thousands)</i>				
E&O reserves at beginning of period	\$ 39,793	\$ 53,302	\$ 44,833	\$ 23,319
Additions	4,949	2,131	12,123	31,296
Release upon sales of product	(2,175)	(1,298)	(8,826)	(2,299)
Scrap	(2,503)	(3,460)	(5,345)	(5,502)
Standards adjustments and other	(1,168)	(864)	(3,889)	2,997
E&O reserves at end of period	\$ 38,896	\$ 49,811	\$ 38,896	\$ 49,811

We have created an action plan at a product line level to scrap approximately 15% of the remaining E&O inventory during the fourth quarter of fiscal 2006, and we are still in the process of evaluating the remaining reserved products. It is possible that some of these reserved products will be sold, which will benefit our gross margin in the period sold. 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.

On a quarterly basis, we also assess the net realizable value of our inventories. When the estimated average selling price, plus costs to sell our inventory falls below our inventory cost, we adjust our inventory to its current estimated market value. During the three months ended June 30, 2006, we recorded \$0.3 million of inventory charges to adjust certain products to their estimated market value. During the nine months ended June 30, 2006 and 2005, we recorded \$3.6 million and \$18.9 million, respectively, of inventory charges to adjust certain wireless networking products to their estimated market value. Increases to this inventory reserve may be required based upon actual average selling prices and changes to our current estimates, which would impact our gross margin percentage in future periods.



Activity in our lower of cost or market (LCM) inventory reserves for the three and nine months ended June 30, 2006 and 2005 was as follows:

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	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>June 30, 2006</b>	<b>June 30, 2005</b>	<b>June 30, 2006</b>	<b>June 30, 2005</b>
<i>(in thousands)</i>				
LCM reserves at beginning of period	\$ 6,228	\$ 11,093	\$ 6,739	\$
Additions	288		3,609	18,854
Release upon sales of product	(1,526)	(1,488)	(5,312)	(5,370)
Standards adjustments and other		(2,588)	(46)	(6,467)
LCM reserves at end of period	\$ 4,990	\$ 7,017	\$ 4,990	\$ 7,017

**Research and Development**

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>June 30, 2006</b>	<b>June 30, 2005</b>	<b>June 30, 2006</b>	<b>June 30, 2005</b>
<i>(in thousands)</i>				
Research and development	\$70,096	\$66,282	\$199,286	\$209,362
Percent of net revenues	28%	34%	27%	41%

Our research and development (R&D) expenses consist principally of direct personnel costs to develop new communications and semiconductor products, allocated direct costs of the R&D function, photo mask and other costs for pre-production evaluation and testing of new devices and design and test tool costs. Our R&D expenses also include the costs for design automation advanced package development and non-cash stock-based compensation charges for R&D personnel.

R&D expense increased \$3.8 million in the third quarter of fiscal 2006 compared to the third quarter of fiscal 2005 primarily due to a \$4.4 million increase in non-cash stock-based compensation expense due to our adoption of Statement of Financial Accounting Standards (SFAS) No. 123(R), Share-Based Payment, in the first quarter of fiscal 2006. This increase was partially offset by \$0.9 million of credits relating to property tax settlements.

R&D expense decreased \$10.1 million in the first nine months of fiscal 2006 compared to the first nine months of fiscal 2005 primarily as a result of our restructuring efforts which streamlined R&D projects and shifted resources to lower cost regions. Also contributing to the decrease in R&D expense was \$4.3 million of credits relating to property tax settlements. These decreases were partially offset by an \$11.0 million increase in non-cash stock-based compensation expense due to our adoption of SFAS No. 123(R) in the first quarter of fiscal 2006.

**Selling, General and Administrative**

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>June 30, 2006</b>	<b>June 30, 2005</b>	<b>June 30, 2006</b>	<b>June 30, 2005</b>
<i>(in thousands)</i>				
Selling, general and administrative	\$27,037	\$31,081	\$101,958	\$89,449
Percent of net revenues	11%	16%	14%	18%

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

SG&A expense decreased \$4.0 million in the third quarter of fiscal 2006 compared to the third quarter of fiscal 2005. This decrease is primarily attributable to a \$5.6 million decrease in legal fees mainly due to the settlement of our intellectual property litigation with Texas Instruments and \$0.9 million of credits related to property tax settlements. These decreases were partially offset by a \$2.8 million increase in non-cash stock-based compensation expense due to

our adoption of SFAS No. 123(R) in the first quarter of fiscal 2006.

SG&A expense increased \$12.5 million in the first nine months of fiscal 2006 compared to the first nine months of fiscal 2005. This increase is primarily attributable to a \$16.8 million increase in non-cash stock-based compensation expense due to our adoption of SFAS No. 123(R) in the first quarter of fiscal 2006 and a \$1.8 million increase in

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legal fees mainly related to the trial and ultimate settlement of our intellectual property litigation with Texas Instruments. These increases were partially offset by \$3.9 million of credits related to property tax settlements.

**Amortization of Intangible Assets**

<i>(in thousands)</i>	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>June 30, 2006</b>	<b>June 30, 2005</b>	<b>June 30, 2006</b>	<b>June 30, 2005</b>
Amortization of intangible assets	\$7,520	\$7,969	\$23,185	\$24,402

Amortization of intangible assets consists of amortization expense for intangible assets acquired in various business combinations. Our intangible assets are being amortized over a weighted-average period of approximately five years. The decrease in amortization expense for the third quarter of fiscal 2006 compared to the second quarter of fiscal 2005 and the first nine months of fiscal 2006 compared to the first nine months of fiscal 2005 is attributable to several intangible assets becoming fully amortized during fiscal 2005 and 2006.

**Special Charges**

<i>(in thousands)</i>	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>June 30, 2006</b>	<b>June 30, 2005</b>	<b>June 30, 2006</b>	<b>June 30, 2005</b>
Litigation charge	\$ 30,000	\$	\$ 70,000	\$
Restructuring charges	2,610	6,731	2,394	24,470
Integration charges (credits)		1,649	(400)	6,760
Asset impairments		29	85	3,492
Other special charges			300	6,540
	\$ 32,610	\$ 8,409	\$ 72,379	\$ 41,262

Special charges for the third quarter of fiscal 2006 consisted of a \$30.0 million charge related to the settlement of our litigation with Texas Instruments, Inc. (see Part II, Item I, Legal Proceedings, for a discussion of the TI litigation settlement) and \$2.6 million of restructuring charges mainly related to our fiscal 2006 restructuring action. Special charges for the first nine months of fiscal 2006 consisted primarily of a \$70.0 million charge related the settlement of our litigation with Texas Instruments and \$2.4 million of restructuring charges. The restructuring charges were comprised of \$3.4 million for employee severance and other termination benefit costs and \$0.4 million of facilities closure costs related to our fiscal 2006 restructuring action and \$1.0 million of facilities related charges resulting from the accretion of rent expense related to our fiscal 2005 restructuring action, partially offset by a \$2.5 million net reduction of the accrual relating to our fiscal 2005 restructuring action due to a revised estimate of the remaining employee severance and termination benefit costs to be paid.

Special charges for the third quarter of fiscal 2005 included \$6.7 million of restructuring charges, consisting of \$5.9 million for employee severance and termination benefit costs and \$0.8 of facilities charges related to our fiscal 2005 restructuring action, and \$1.6 million of integration charges related to the merger with GlobespanVirata. Special charges for the first nine months of fiscal 2005 were comprised of \$24.5 million of restructuring charges, consisting of \$19.4 million for employee severance and termination benefit costs and \$5.1 of facilities charges related to our fiscal 2005 restructuring action, \$6.8 million of integration charges related to the merger with GlobespanVirata, asset impairment charges of \$3.5 million primarily associated with leasehold improvements in facilities that were vacated as part of our restructuring activities, and \$6.5 million of other special charges consisting of \$3.2 million for the settlements of legal matters, \$2.3 million of stock option and warrant modification charges, and \$1.0 million of other special charges.

**Table of Contents****Interest Expense**

<i>(in thousands)</i>	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>June 30, 2006</b>	<b>June 30, 2005</b>	<b>June 30, 2006</b>	<b>June 30, 2005</b>
Interest expense	\$ 10,426	\$ 8,396	\$ 29,280	\$ 25,290

Interest expense is primarily related to our convertible subordinated notes and, beginning in the first quarter of fiscal 2006, to borrowings under a short-term credit facility.

Interest expense increased in the three and nine months ended June 30, 2006 compared to the three and nine months ended June 30, 2005 as a result of the short-term credit facility we established in November 2005. The increase in interest expense as a result of the \$250.0 million principal amount of 4.00% convertible subordinated notes issued in March 2006 and May 2006 has been substantially offset by a decrease in interest expense as a result of the retirement of the \$130.0 million principal amount of 5.25% convertible subordinated notes and the \$66.8 million principal amount of 4.25% convertible subordinated notes in May 2006, as well as the repurchase of \$58.5 million principal amount of 4.00% convertible subordinated notes due February 2007.

**Other Expense (Income), Net**

<i>(in thousands)</i>	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>June 30, 2006</b>	<b>June 30, 2005</b>	<b>June 30, 2006</b>	<b>June 30, 2005</b>
Investment and interest income	\$ (4,518)	\$ (2,182)	\$ (14,415)	\$ (3,956)
Decrease in fair value of the Mindspeed warrant	35,131	16,085	3,800	14,804
Impairment loss of Skyworks shares	18,456		18,456	
Losses of equity method investments	648	2,127	3,303	8,587
Realized gains on sales of equity securities		(31,198)	(4,414)	(42,310)
Other	190	(442)	(307)	(492)
	\$ 49,907	\$ (15,610)	\$ 6,423	\$ (23,367)

Other expense (income), net for the third quarter of fiscal 2006 consisted mainly of a \$35.1 million decrease in the fair value of the Mindspeed warrant, which resulted primarily from a decrease in the fair value of Mindspeed's common stock during the period, and an \$18.5 million charge for the impairment of our Skyworks shares, partially offset by \$4.5 million of investment and interest income. Other expense (income), net for the first nine months of fiscal 2006 was primarily comprised of the \$18.5 million charge for the impairment of our Skyworks shares, a \$3.8 million decrease in the fair value of the Mindspeed warrant, and \$3.3 million of losses from our equity method investments, partially offset by \$14.4 million of investment and interest income and \$4.4 million of gains on sales of equity securities.

Other expense (income), net for the third quarter of fiscal 2005 consisted of \$31.2 million in gains on sales of equity securities, primarily our investment in SiRF Technologies Holdings, Inc., and \$2.2 million of investment and interest income, partially offset by a \$16.1 million decrease in the fair value of the Mindspeed warrant and \$2.1 million of losses from our equity method investments. Other expense (income), net for the first nine months of fiscal 2005 consisted of \$42.3 million in gains on sales of equity securities, primarily our investment in SiRF Technologies Holdings, Inc., and \$4.0 million of investment and interest income, partially offset by a \$14.8 million decrease in the fair value of the Mindspeed warrant and \$8.6 million of losses from our equity method investments.

**Provision for Income Taxes**

We recorded income tax expense of \$1.0 million and \$0.7 million for the third quarter of fiscal 2006 and 2005, respectively, and \$2.5 million and \$1.8 million for the first nine months of fiscal 2006 and 2005, respectively, primarily reflecting income taxes imposed on our foreign subsidiaries. No U.S. Federal income tax expense was

recorded for any of these periods as all of our Federal and the majority of our state income taxes are offset by fully reserved deferred tax assets. Except to the extent of the Federal and state alternative minimum tax (AMT), we

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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 June 30, 2006, we had approximately \$1.2 billion of fully reserved deferred tax assets, which are primarily related to U.S. Federal income tax net operating loss (NOL) carryforwards and which can be used to offset taxable income in subsequent years. Approximately \$456.0 million of the NOL carryforwards were acquired in business combinations, and if we receive a tax benefit from their utilization, the benefit will be recorded as a reduction to goodwill. The deferred tax assets acquired in the merger with GlobespanVirata are subject to limitations imposed by section 382 of the Internal Revenue Code. Such limitations are not expected to impair our ability to utilize these deferred tax assets.

We are subject to income taxes in both the United States and numerous foreign jurisdictions and have also acquired and divested certain businesses for which we have retained certain tax liabilities. In the ordinary course of our business, there are many transactions and calculations where the ultimate tax determination is uncertain and significant judgment is required in determining our worldwide provision for income taxes. We and our acquired and divested businesses are regularly under audit by tax authorities. Although we believe our tax estimates are reasonable, the final determination of tax audits could be different than that which is reflected in historical income tax provisions and accruals. Based on the results of an audit, a material effect on our income tax provision, net income, or cash flows in the period or periods for which that determination is made could result.

**Liquidity and Capital Resources**

As of June 30, 2006, we had a total of \$706.5 million aggregate principal amount of convertible subordinated notes outstanding, of which \$456.5 million is due in February 2007 and \$250.0 million is due in March 2026. The conversion price of the notes due in February 2007 is currently substantially in excess of the market value of our common stock. We also have an \$80.0 million credit facility with a bank, under which we had borrowed \$80.0 million as of June 30, 2006. This credit facility has an initial term of 364 days, which expires in November 2006 and which is subject to 364-day renewal periods at the discretion of the bank. As of June 30, 2006, we had negative working capital of \$148.9 million, compared to positive working capital of \$142.8 million at September 30, 2005.

In addition to our \$365.8 million of cash, cash equivalents and marketable securities at June 30, 2006, our principal sources of liquidity will be cash generated from its operations, if any, and additional financing. For the nine months ended June 30, 2006, we incurred a net loss of \$101.5 million and negative cash flows from operations of \$54.3 million. Both the net loss and the negative cash flows from operations for the nine months ended June 30, 2006 were negatively impacted by a \$70.0 million patent lawsuit settlement with Texas Instruments, Inc. Our cash, cash equivalents and marketable securities include 6.2 million shares of common stock of Skyworks Solutions, Inc. valued at \$34.1 million as of June 30, 2006. For these securities, there is risk associated with the overall state of the stock market, having available buyers for the shares we may want to sell, and ultimately being able to liquidate the securities at a favorable price in a short period of time. There can be no assurance that the carrying value of these securities will ultimately be realized. The closing price of Skyworks common stock on June 30, 2006 and August 4, 2006 was \$5.51 and \$4.44 per share, respectively. This additional per share decline since the end of our third fiscal quarter of 2006 represents an additional decline in our cash, cash equivalents and marketable securities of approximately \$6.6 million.

Based on our current cash flow forecasts, we do not believe we will be able to generate sufficient cash flows from our operations and through any liquidation of our investments and other assets in order to meet our February 2007 debt obligations without also obtaining additional financing of approximately \$200 million. We are currently evaluating several different financing alternatives and are currently focused on high-yield debt and term loans, as these instruments would not be dilutive to existing shareholders. We believe that we will be able to obtain the necessary financing and meet our February 2007 debt obligations; however, we cannot assure you that we will have access to additional sources of financing, or be able to refinance our existing debt, on favorable terms or at all.

We also have an investment in Jazz Semiconductor, Inc., a warrant to purchase 30 million shares of Mindspeed Technologies, Inc. common stock, and other assets, including real estate. As a result of current market conditions related to the value of these investments, as well as our limited ability to liquidate these assets, current cash flow forecasts through the due date of our February 2007 debt obligations do not assume any liquidation of these





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investments. Our investment in Jazz is reflected as a long-term asset on the accompanying condensed consolidated balance sheet as of June 30, 2006. Although Jazz has filed a Registration Statement on Form S-1 regarding its intent to complete an initial public offering of its common stock, Jazz is currently a privately-held company and, as a result, our ability to liquidate this investment is limited. Further, there can be no assurance that Jazz will successfully complete its initial public offering or, if it does, that we would be able to sell a significant portion of our investment prior to the due date of our February 2007 debt obligations. The value of the Mindspeed warrant of \$29.3 million is also reflected as a long-term asset on the accompanying condensed consolidated balance sheet as of June 30, 2006. The valuation of this derivative instrument is subjective, and at any point in time could ultimately result in the realization of amounts significantly different than the carrying value. Further, there is no assurance that the equity markets would allow us to liquidate a substantial portion of this warrant within a short time period without significantly impacting the market value. The closing price of Mindspeed's common stock on June 30, 2006 and August 4, 2006 was \$2.41 and \$1.49 per share, respectively. This additional per share decline since the end of our third fiscal quarter of 2006 represents an additional decline in the value of this warrant.

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

<i>(in thousands)</i>	<b>June 30, 2006</b>	<b>September 30, 2005</b>
Cash and cash equivalents	\$ 225,461	\$ 202,704
Short-term marketable debt securities (primarily U.S. government agency and corporate debt securities)	106,292	95,902
Long-term marketable debt securities (primarily U.S. government agency and corporate debt securities)		38,485
Subtotal	331,753	337,091
Marketable equity securities (6.2 million shares of Skyworks Solutions, Inc.)	34,068	43,404
Total cash, cash equivalents and marketable securities	\$ 365,821	\$ 380,495

Our cash, cash equivalents and marketable securities decreased by \$14.7 million from \$380.5 million at September 30, 2005 to \$365.8 million at June 30, 2006. The decline in value of our investment in Skyworks accounted for \$9.3 million of this decrease. The remaining decline of \$5.4 million is attributable to net cash used in operating and investing activities, including the \$70.0 million payment to Texas Instruments as a result of a patent litigation settlement, offset by net cash provided by financing activities of \$84.6 million during the period.

Included in our cash, cash equivalents and marketable securities of \$365.8 million as of June 30, 2006 are 6.2 million shares of common stock of Skyworks Solutions, Inc. valued at \$34.1 million. For these securities, there is risk associated with the overall state of the stock market, having available buyers for the shares we may want to sell, and ultimately being able to liquidate the securities at a favorable price. There can be no assurance that the carrying value of these assets will ultimately be realized.

As of June 30, 2006, we had negative working capital of \$148.9 million, compared to positive working capital of \$142.8 million at September 30, 2005. In addition to our cash, cash equivalents and marketable securities, our principal source of liquidity is cash generated from our operations, if any. We also have an investment in Jazz Semiconductor, Inc., a warrant to purchase 30 million shares of Mindspeed Technologies, Inc. common stock and other assets, including real estate.

Our investment in Jazz is reflected as a long-term asset on our accompanying condensed consolidated balance sheet as of June 30, 2006. Although Jazz has filed a Registration Statement on Form S-1 regarding its intent to complete an initial public offering of its common stock, Jazz is currently a privately-held company and, as a result, our ability to liquidate this investment is limited. The value of the Mindspeed warrant of \$29.3 million is also reflected as a

long-term asset on our accompanying condensed consolidated balance sheet as of June 30, 2006. The valuation of this derivative instrument is subjective, and at any point in time could ultimately result in the realization of amounts significantly different than the carrying value. Further, there is no assurance that the equity markets would allow us to liquidate a substantial portion of this warrant within a short time period without significantly impacting the market value.

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Cash flows are as follows:

<i>(in thousands)</i>	<b>Nine Months Ended</b>	
	<b>June 30, 2006</b>	<b>June 30, 2005</b>
Net cash (used in) operating activities	\$ (54,263)	\$ (58,666)
Net cash (used in) provided by investing activities	(7,639)	79,195
Net cash provided by financing activities	84,659	936
Net increase in cash and cash equivalents	\$ 22,757	\$ 21,465

Cash used in operating activities was \$54.3 million for the first nine months of fiscal 2006 compared to \$58.7 million for the first nine months of fiscal 2005. Cash flows generated from operations during the first nine months of fiscal 2006 were \$57.3 million, which was more than offset by \$23.3 million of net unfavorable changes in our working capital (accounts receivable, inventories and accounts payable), a \$70.0 million payment related to the settlement of our litigation with Texas Instruments, Inc., and \$18.3 million of payments related to other special charge and restructuring related items. The net unfavorable working capital change was mainly caused by an increase in days sales outstanding (DSO) from 37 days in the September 2005 quarter to 53 days in the June 2006 quarter. This DSO increase was a result of (i) the timing of shipments in the third quarter of fiscal 2006 as compared to the fourth quarter of fiscal 2005 as a result of supply availability in the third quarter of fiscal 2006 and (ii) higher levels of aged receivables as compared to the fourth quarter of fiscal 2005. The unfavorable change in working capital due to the increase in DSO was partially offset by a reduction in our inventory balance, as inventory turns increased from 5.4 turns in the September 2005 quarter to 6.6 turns in the June 2006 quarter.

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

Cash used in investing activities was \$7.6 million for the first nine months of fiscal 2006 compared to cash provided by investing activities of \$79.2 million for the first nine months of fiscal 2005. The cash used in investing activities in the first nine months of fiscal 2006 was primarily attributable to \$23.5 million of capital expenditures partially due to our expansion efforts in India and China, \$8.8 million of restricted cash as required under our new credit facility, and \$6.9 million of payments related to a previous business combination. These cash outflows from investing activities were partially offset by \$27.1 million of net proceeds from sales and maturities of marketable securities, and \$5.2 million of proceeds from sales of non-marketable equity securities. Cash provided by investing activities of \$79.2 million for the first nine months of fiscal 2005 includes net proceeds of \$49.1 million received from the purchase and sale-leaseback of our headquarters facility, \$44.4 million of proceeds from the sales of equity securities, primarily in SiRF Technology Holdings, Inc., and net proceeds from sales and maturities of marketable securities of \$23.6 million. These cash inflows from investing activities were partially offset by payments for acquisitions of \$18.8 million, capital expenditures of \$16.4 million, and investment in businesses of \$2.6 million.

Cash provided by financing activities was \$84.7 million for the first nine months of fiscal 2006 compared to \$0.9 million for the first nine months of fiscal 2005. The cash provided by financing activities in the first nine months of fiscal 2006 consisted of net proceeds of \$243.6 from the issuance of convertible subordinated notes due March 2026, \$78.5 million of net proceeds from our new credit facility and \$17.1 million of proceeds from the issuance of common stock under our stock-based employee benefit plans. These cash inflows from financing activities were partially offset by the retirement of \$196.8 million of our convertible subordinated notes due May 2006 and \$57.9 million of repurchases and retirements of a portion of our convertible subordinated notes due February 2007.

The cash provided by financing activities in the first nine months of fiscal 2005 consisted primarily of \$0.7 million of proceeds from the issuance of common stock under our stock-based employee benefit plans.

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Contractual obligations at June 30, 2006 are as follows:

<i>(in millions)</i>	<b>Payments due by period</b>				
	<b>Total</b>	<b>Less than 1 year</b>	<b>1-3 years</b>	<b>3-5 years</b>	<b>More than 5 years</b>
Long-term debt	\$ 706.5	\$ 456.5	\$	\$	\$ 250.0
Short-term debt	80.0	80.0			
Interest on debt	220.1	30.1	20.0	20.0	150.0
Operating leases	172.6	31.2	35.4	28.5	77.5
Assigned leases	5.5	2.2	1.4	1.3	0.6
Capital commitments	4.9	4.9			
	\$ 1,189.6	\$ 604.9	\$ 56.8	\$ 49.8	\$ 478.1

At June 30, 2006, the Company had many sublease arrangements on operating leases for terms ranging from near term to approximately ten years. Aggregate scheduled sublease income based on current terms is approximately \$31.9 million.

**Off-Balance Sheet Arrangements**

We have made guarantees and indemnities, under which we may be required to make payments to a guaranteed or indemnified party, in relation to certain transactions. In connection with our spin-off from Rockwell International Corporation, we 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 our contribution of certain of our manufacturing operations to Jazz Semiconductor, Inc., we agreed to indemnify Jazz for certain environmental matters and other customary divestiture-related matters. In connection with the sales of our products, we provide intellectual property indemnities to our customers. In connection with certain facility leases, we have indemnified our lessors for certain claims arising from the facility or the lease. We indemnify our directors and officers to the maximum extent permitted under the laws of the State of Delaware.

The durations of our guarantees and indemnities vary, and in many cases are 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 we could be obligated to make. We have not recorded any liability for these guarantees and indemnities in our consolidated balance sheets. Product warranty costs are not significant.

**Special Purpose Entities**

We have one special purpose entity, Conexant USA, LLC, which was formed in September 2005 in anticipation of establishing an accounts receivable financing facility. This special purpose entity is a wholly-owned, consolidated subsidiary of the Company. Neither Conexant USA's assets nor its credit may be used to satisfy the obligations of the Company or any other subsidiaries of the Company.

On November 29, 2005, we established an accounts receivable financing facility whereby we will sell, from time to time, certain insured accounts receivable to Conexant USA, and Conexant USA entered into an \$80.0 million revolving credit agreement with a bank which is secured by the assets of the special purpose entity. See Note 3 of Notes to Condensed Consolidated Financial Statements for further information.

**Recent Accounting Pronouncements**

In July 2006, the FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* an interpretation of FASB Statement No. 109 (FIN 48). This interpretation clarifies the application of SFAS No. 109, *Accounting for Income Taxes*, by defining a criterion than an individual tax position must meet for any part of the benefit of that position to be recognized in an enterprise's financial statements and also provides guidance on measurement,

derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006, but earlier adoption is permitted.

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We will adopt FIN 48 no later than October 1, 2007. We are currently assessing the impact the adoption of FIN 48 will have on our financial position and results of operations.

In May 2005, the Financial Accounting Standards Board (FASB) issued SFAS No. 154, Accounting Changes and Error Corrections, which replaces APB Opinion No. 20, Accounting Changes, and SFAS No. 3, Reporting Accounting Changes in Interim Financial Statements. SFAS No. 154 applies to all voluntary changes in accounting principles and requires retrospective application (a term defined by the statement) to prior periods' financial statements, unless it is impracticable to determine the effect of a change. It also applies to changes required by an accounting pronouncement that does not include specific transition provisions. SFAS No. 154 is effective for fiscal years beginning after December 15, 2005. We will adopt SFAS No. 154 on October 1, 2006 and do not expect that the adoption will have a material impact on our financial position or results of operations.

In February 2006, the FASB issued SFAS No. 155, Accounting for Certain Hybrid Financial Instruments—an amendment of FASB Statements No. 133 and 140. SFAS No. 155 permits fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation, clarifies which interest-only strips and principal-only strips are not subject to the requirements of SFAS No. 133, establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation, clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives, and amends SFAS No. 140 to eliminate the prohibition on a qualifying special-purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument. SFAS No. 155 is effective for all financial instruments acquired or issued after the beginning of an entity's first fiscal year that begins after September 15, 2006. We will adopt SFAS No. 155 on October 1, 2006 and do not expect that the adoption will have a material impact on our financial position or results of operations.

**Critical Accounting Policies**

The preparation of financial statements in accordance with accounting principles generally accepted in the United States requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Among the significant estimates affecting our consolidated financial statements are those relating to business combinations, revenue recognition, allowances for doubtful accounts, inventories, long-lived assets, deferred income taxes, valuation of warrants, non-marketable equity securities, stock-based compensation, restructuring charges and employee benefit plans. 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 in-process research and development (IPR&D), we typically engage a third party valuation firm to assist management in determining those values. Valuation of intangible assets and IPR&D entails significant estimates and assumptions including, but not limited to: determining the timing and expected costs to complete projects, estimating future cash flows from product sales, and developing appropriate discount rates and probability rates by project. We believe that the fair values assigned to the assets acquired and liabilities assumed are based on reasonable assumptions. To the extent actual results differ from those estimates, our future results of operations may be affected by incurring charges to our statements of operations. Additionally, estimates for purchase price allocations may change as subsequent information becomes available.

***Revenue recognition***

Revenue is recognized when (i) the risk of loss has been transferred to the customer, (ii) price and terms are fixed, (iii) no significant vendor obligation exists, and (iv) collection of the receivable is reasonably assured. These terms





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are typically met upon shipment of product to the customer, except for certain distributors who have a contractual right of return or for whom the contractual terms were not enforced. Revenue with respect to these distributors is deferred until the purchased products are sold by the distributor to a third party. Other distributors have limited stock rotation rights, which allow them to rotate up to 10% of product in their inventory two times a year. We recognize revenue to these distributors upon shipment of product to the distributor, as the stock rotation rights are limited and we believe that we have the ability to reasonably estimate and establish allowances for expected product returns in accordance with SFAS No. 48, *Revenue Recognition When Right of Return Exists*. Our revenue recognition policy is significant because our revenue is a key component of our operations and the timing of revenue recognition determines the timing of certain expenses, such as sales commissions. Revenue results are difficult to predict, and any shortfall in revenues could cause our operating results to vary significantly from period to period.

We have many distributor customers for whom revenue is recognized upon shipment of product to them, as the contractual terms provide for limited or no rights of return. During the three months ended December 31, 2004, we determined that we were unable to enforce our contractual terms with three distribution customers. As a result, from October 1, 2004, we have deferred the recognition of revenue on sales to these three distributors until the purchased products are sold by the distributors to a third party. At June 30, 2006, deferred revenue related to sales to distributors was \$6.9 million. As of June 30, 2006, we also have deferred revenue of \$6.5 million related to shipments of products for which we have on-going obligations. Deferred revenue is included in other current liabilities on the accompanying condensed consolidated balance sheets.

***Allowance for doubtful accounts***

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

***Inventories***

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

***Long-lived assets***

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



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Goodwill is tested for impairment annually, or when a possible impairment is indicated, using the fair value based test prescribed by SFAS No. 142. The estimates and assumptions described above (along with other factors such as discount rates) will affect the outcome of our impairment tests and the amounts of any resulting impairment losses.

***Deferred income taxes***

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

***Valuation of warrants***

We have a warrant to purchase 30 million shares of Mindspeed Technologies, Inc. common stock. The fair value of the Mindspeed warrant is determined using a standard Black-Scholes-Merton valuation model with assumptions consistent with current market conditions and our intent to liquidate the warrant over a specified time period. The Black-Scholes-Merton valuation 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.

***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 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. We have experienced substantial impairments in the value of our non-marketable equity securities investments over the past few years. 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.

***Stock-based compensation***

In December 2004, the FASB issued SFAS No. 123(R), Share-Based Payment. This pronouncement amends SFAS No. 123, Accounting for Stock-Based Compensation, and supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees. SFAS No. 123(R) requires that companies account for awards of equity instruments issued to employees under the fair value method of accounting and recognize such amounts in their statements of operations. We adopted SFAS No. 123(R) on October 1, 2005 using the modified prospective method and, accordingly, have not restated the consolidated statements of operations for prior interim periods or fiscal years. Under SFAS No. 123(R), we are required to measure compensation cost for all stock-based awards at fair value on the date of grant and recognize compensation expense in our consolidated statements of operations over the service period that the awards are expected to vest. As permitted under SFAS No. 123(R), we have elected to recognize compensation cost for all options with graded vesting granted on or after October 1, 2005 on a straight-line basis over the vesting period of the entire option. For options with graded vesting granted prior to October 1, 2005, we will continue to recognize compensation cost over the vesting period following the accelerated recognition method

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described in FASB Interpretation No. 28, Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans, as if each underlying vesting date represented a separate option grant.

Prior to the adoption of SFAS No. 123(R), we accounted for employee stock-based compensation using the intrinsic value method in accordance with APB Opinion No. 25, as permitted by SFAS No. 123 and SFAS No. 148,

Accounting for Stock-Based Compensation Transition and Disclosure. Under the intrinsic value method, the difference between the market price on the date of grant and the exercise price is charged to the statement of operations over the vesting period. Prior to the adoption of SFAS No. 123(R), we recognized compensation cost only for stock options issued with exercise prices set below market prices on the date of grant, which consisted principally of stock options granted to replace stock options of acquired businesses, and provided the necessary pro forma disclosures required under SFAS No. 123.

Under SFAS No. 123(R), we now record in our consolidated statements of operations (i) compensation cost for options granted, modified, repurchased or cancelled on or after October 1, 2005 under the provisions of SFAS No. 123(R) and (ii) compensation cost for the unvested portion of options granted prior to October 1, 2005 over their remaining vesting periods using the amounts previously measured under SFAS No. 123 for pro forma disclosure purposes. Under the transition provisions of SFAS No. 123(R), we have recognized a cumulative effect of a change in accounting principle to reduce additional paid-in capital by \$20.7 million, consisting of (i) the remaining \$12.5 million deferred stock-based compensation balance as of October 1, 2005, primarily accounted for under APB Opinion No. 25, and (ii) the \$8.2 million difference between the remaining \$12.5 million deferred stock-based compensation balance as of October 1, 2005 for the options issued in our business combinations and the remaining unamortized grant-date fair value of these options, which also reduced goodwill.

Consistent with the valuation method for the disclosure-only provisions of SFAS No. 123, we are using the Black-Scholes-Merton model to value the compensation expense associated with stock-based awards under SFAS No. 123(R). In addition, forfeitures are estimated when recognizing compensation expense, and the estimate of forfeitures will be adjusted over the requisite service period to the extent that actual forfeitures differ, or are expected to differ, from such estimates. Changes in estimated forfeitures will be recognized through a cumulative catch-up adjustment in the period of change and will also impact the amount of compensation expense to be recognized in future periods.

The Black-Scholes-Merton model requires certain assumptions to determine an option fair value, including expected stock price volatility, risk-free interest rate, and expected life of the option. The expected stock price volatility rates are based on the historical volatility of our common stock. The risk free interest rates are based on the U.S. Treasury yield curve in effect at the time of grant for periods corresponding with the expected life of the option or award. The average expected life represents the weighted average period of time that options or awards granted are expected to be outstanding, as calculated using the simplified method described in the Securities and Exchange Commission's Staff Accounting Bulletin No. 107.

***Restructuring charges***

From time to time we announce restructuring activities and record related charges in our consolidated statements of operations. To date, these charges have related 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 that the assumptions are made, for example the timing and amount of sublease income that will be achieved on vacated property and the operating costs to be paid until lease termination, and the discount rates used in determining the present value (fair value) of remaining minimum lease payments on vacated properties. While we have used our best estimates based on facts and circumstances available at the time, different estimates reasonably could have been used in the relevant periods, and the actual results may be different, and those differences could have a material impact on the presentation of our financial position or results of operations. Our policies require us to review the estimates and assumptions periodically and reflect the effects of any revisions in the period that they are determined to be necessary. Such amounts also contain estimates and assumptions made by management, and are reviewed periodically and adjusted accordingly.

**Table of Contents*****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 rates used are representative of high-quality fixed income investments. The other assumptions do not tend to change materially over time. We evaluate all assumptions annually and they are updated to reflect our experience.

**Risk Factors**

Our business, financial condition and operating results can be impacted by a number of risk 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.

References in this section to our fiscal year refer to the fiscal year ending on the Friday nearest September 30 of each year.

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

At June 30, 2006, we had \$706.5 million aggregate principal amount of convertible subordinated notes outstanding, of which \$456.5 million is due in February 2007 and \$250.0 million is due in March 2006. The conversion price of the notes that are due in February 2007 are currently substantially in excess of the market value of our common stock. We also have \$80.0 million of short-term debt which expires in November 2006 and is subject to extension at the discretion of the lender. At June 30, 2006, we had cash, cash equivalents and marketable securities of \$365.8 million. Working capital was negative as of June 30, 2006 due to the reclassification of our convertible subordinated notes due February 2007 into a current liability account. We do not believe we will be able to generate sufficient cash flows from our operations and realize additional value from our investments and other assets in order to meet our February 2007 debt obligations without additional financing of approximately \$200 million. We are currently evaluating several different financing alternatives and are currently focused on high-yield debt and term loans, as these instruments would not be dilutive to existing shareholders. We believe that we will be able to obtain the necessary financing and meet our February 2007 debt obligations; however, we cannot assure you that we will have access to additional sources of financing, or be able to refinance our existing debt, on favorable terms or at all. Further, raising capital through the equity markets would have a greater effect on shareholder dilution. Included in our cash, cash equivalents and marketable securities of \$365.8 million as of June 30, 2006 are 6.2 million shares of common stock of Skyworks Solutions, Inc. valued at \$34.1 million. For these securities, there is risk associated with the overall state of the stock market, having available buyers for the shares we may want to 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. The closing price of Skyworks common stock on June 30, 2006 and August 4, 2006 was \$5.51 and \$4.44 per share, respectively. This additional per share decline since the end of our third fiscal quarter of 2006 represents an additional decline in our cash, cash equivalents and marketable securities of approximately \$6.6 million.

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

***We 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

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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 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.

***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;

our ability to repay our debt;

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;

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

judgments favorable or adverse to us.

In addition, public stock markets have experienced, and are currently experiencing, 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 have recently incurred substantial losses and we anticipate additional future losses.***

Our net losses for the first nine months of fiscal 2006 and for fiscal 2005 were \$101.5 million and \$176.0 million, respectively. We have implemented a number of expense reduction and restructuring initiatives to improve our operating cost structure. The cost reduction initiatives included workforce reductions, the closure or consolidation of certain facilities and an increasing shift of product development resources to lower-cost regions, among other actions. However, these expense reduction initiatives alone will not return us to profitability. In order to return to profitability, we must achieve substantial revenue growth. We cannot assure you as to whether or when we will return to profitability or whether we will be able to sustain such profitability, if achieved.

***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. We have experienced these cyclical fluctuations in our business in the past and may experience them in the future.

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

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

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

- changes in end-user demand for the products manufactured and sold by our customers;
- the timing of receipt, reduction or cancellation of significant orders by customers;
- seasonal customer demand;
- the gain or loss of significant customers;
- market acceptance of our products and our customers' products;
- our ability to develop, introduce and market new products and technologies on a timely basis;
- the timing and extent of product development costs;
- new product and technology introductions by competitors;
- changes in the mix of products we develop and sell;
- fluctuations in manufacturing yields;
- availability and cost of products from our suppliers;
- intellectual property disputes; and

the effects of competitive pricing pressures, including decreases in average selling prices of our products.

The foregoing factors are difficult to forecast, and these as well as other factors could materially adversely affect our quarterly or annual operating results.

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

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

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

- time-to-market;



product quality, reliability and performance;

level of integration;

price and total system cost;

compliance with industry standards;

design and engineering capabilities;

strategic relationships with customers;

customer support;

new product innovation; and

access to manufacturing capacity.

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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.

***The loss of a key customer could seriously impact our revenue levels and harm our business. In addition, if we are unable to continue to sell existing and new products to our key customers in significant quantities or to attract new significant customers, our future operating results could be adversely affected.***

We have derived a substantial portion of our past revenue from sales to a relatively small number of customers. As a result, the loss of any significant customer could materially and adversely affect our financial condition and results of operations.

Sales to our twenty largest customers represented approximately 66% and 64% of our net revenues in the first nine months of fiscal 2006 and for fiscal 2005, respectively. We expect that our largest customers will continue to account for a substantial portion of our net revenue in future periods. The identities of our largest customers and their respective contributions to our net revenue have varied and will likely continue to vary from period to period. We may not be able to maintain or increase sales to certain of our key customers for a variety of reasons, including the following:

- most of our customers can stop incorporating our products into their own products with limited notice to us and suffer little or no penalty;

- our agreements with our customers typically do not require them to purchase a minimum quantity of our products;

- many of our customers have pre-existing or concurrent relationships with our current or potential competitors that may affect the customers' decisions to purchase our products;

- our customers face intense competition from other manufacturers that do not use our products; and

- some of our customers offer or may offer products that compete with our products.

In addition, our longstanding relationships with some larger customers may also deter other potential customers who compete with these customers from buying our products. To attract new customers or retain existing customers, we may offer certain customers favorable prices on our products. The loss of a key customer, a reduction in sales to any key customer or our inability to attract new significant customers could seriously impact our revenue and materially and adversely affect our results of operations.

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

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

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

- our ability to accurately define new products;

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

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

- overall market acceptance of our products;

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

our ability to transition product development efforts between and among our sites, particularly into India and China.

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As a result of the Paxonet Communications acquisition in December 2004 and organic growth, we have increased our headcount in India from approximately 180 employees to approximately 1,040 employees at several design centers since the end of fiscal 2004. We plan to continue this growth trend in India and other international locations in the Asia-Pacific region. Expansion and transition of product development efforts to other locations entails risks associated with our ability to manage the development of products at remote geographic locations, to achieve key program milestones, and to attract and retain qualified management, technical and other personnel necessary for the design and development of our products. If we experience product design or development delays as a result of the transition, or an inability to adequately staff the programs, there could be a material adverse effect on our results of operations. We cannot assure you that we will have sufficient resources to make the substantial investment in research and development in order to develop and bring to market new and enhanced products. Furthermore, we are required to continually evaluate expenditures for planned product development and to choose among alternative technologies based on our expectations of future market growth. We cannot assure you that we will be able to develop and introduce new or enhanced products in a timely and cost-effective manner, that our products will satisfy customer requirements or achieve market acceptance, or that we will be able to anticipate new industry standards and technological changes. We also cannot assure you that we will be able to respond successfully to new product announcements and introductions by competitors.

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

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

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

issuances of equity securities dilutive to our existing shareholders;

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

the incurrence of substantial debt and assumption of unknown liabilities;

the potential loss of key employees from the acquired company;

amortization expenses related to intangible assets; and

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

Additionally, in periods subsequent to an acquisition, at least on an annual basis or when indicators of impairment exist, we must evaluate goodwill and acquisition-related intangible assets for impairment. When such assets are found to be impaired, they will be written down to estimated fair value, with a charge against earnings. At June 30, 2006, we have \$711.6 million of goodwill, of which approximately \$616.7 million was generated in our merger with GlobespanVirata in February 2004. When market capitalization is below book value, it is an indicator that goodwill may be impaired. Although our market capitalization was above our book value at June 30, 2006, it has been below book value in the recent past. If our market capitalization drops below our book value for a prolonged period of time or our current assumptions regarding our future operating performance change, we may be required to write down the value of our goodwill by taking a non-cash charge against earnings.

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 process

of integrating operations could cause an interruption of, or loss of momentum in, the activities of one or more of our product lines and the loss of key personnel. The diversion of management's attention and any delays or

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difficulties encountered in connection with acquisitions and the integration of multiple operations could have an adverse effect on our business, results of operations or financial condition.

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

For the first nine months of fiscal 2006 and for fiscal 2005, approximately 89% and 90%, respectively, of our net revenues were from customers located outside of the United States, primarily in the Asia-Pacific region and Europe. In addition, a significant portion of our workforce, including approximately 1,040 employees in India, and many of our key suppliers are located outside the United States. Our international operations consist of research and development, sales offices, and other general and administrative functions. We plan to continue our international expansion, particularly in the Asia-Pacific region. Our international operations are subject to a number of risks inherent in operating abroad. These include, but are not limited to, risks regarding:

currency exchange rate fluctuations;

local economic and political conditions;

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

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

changes in legal or regulatory requirements;

difficulty in obtaining distribution and support;

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

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

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

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

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

We also conduct a significant portion of our international sales through distributors. Sales to distributors and other resellers accounted for approximately 35% and 28% of our net revenues for the first nine months of fiscal 2006 and for fiscal 2005, respectively. Our arrangements with these distributors are terminable at any time, and the loss of these arrangements could have an adverse effect on our operating results. For those international distributors that we account for under a deferred revenue recognition model, we rely on the distributor to provide us timely and accurate product sell through information. No assurances can be given that these international distributors will continue to provide us this information. If we are unable to obtain this information on a timely basis, or if we determine that the information we do receive is unreliable, it may affect the accuracy of amounts recorded in our consolidated financial statements, and therefore have an adverse effect on our operating results.

***We may 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;

frequent new product introductions and enhancements;

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

evolving industry standards.

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

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

Our future success depends on our ability to attract and to retain the continued service and availability of skilled personnel, including our Chairman of the Board and Chief Executive Officer, members of our executive team, and those in design, technical, marketing and staff positions. 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. In addition, we have relied on our ability to grant stock options as one mechanism for recruiting and retaining highly skilled talent. Recent accounting regulations requiring the expensing of stock options may impair our future ability to provide these incentives without incurring significant compensation costs. There can be no assurance that we will continue to successfully attract, motivate, and retain key personnel.

***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 35% and 28% of our net revenues for the first nine months of fiscal 2006 and for fiscal 2005, respectively. Our distributors may offer products of several different suppliers, including products that may be competitive with ours. Accordingly, there is





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a risk that the distributors may give priority to other supplier products and may not sell our products as quickly as forecasted, which may impact their future order levels. We routinely purchase inventory based on estimates of end-market demand for our customers' products, which is difficult to predict. This difficulty may be compounded when we sell to OEMs indirectly through distributors and other resellers or contract manufacturers, or both, as our forecasts of demand are then based on estimates provided by multiple parties. In addition, our customers may change their inventory practices on short notice for any reason. The cancellation or deferral of product orders, the return of previously sold products or overproduction due to the failure of anticipated orders to materialize could result in our holding excess or obsolete inventory, which could result in write-downs of inventory. For example, the reduced demand outlook for fiscal year 2005 and the further decline of average selling prices for certain of our products resulted in net inventory charges of approximately \$45.0 million in the first quarter of fiscal 2005.

***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 or fabs). Under our fabless business model, our revenue growth is dependent on our ability to obtain sufficient external manufacturing capacity, including wafer production capacity. If the semiconductor industry experiences a shortage of wafer fabrication capacity in the future, we may experience delays in shipments or increased manufacturing costs. We do not have any long-term supply arrangements.

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

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

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

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

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

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

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

The foundries and other suppliers on whom we rely may experience financial difficulties or suffer disruptions in their operations due to causes beyond our control, including labor strikes, work stoppages, electrical power outages, fire, earthquake, flooding or other natural disasters. Certain of our suppliers' manufacturing facilities are located near major earthquake fault lines in California and the Asia-Pacific region. In the event of a disruption of the operations of one or more of our suppliers, we may not have a second manufacturing source immediately available. Such an event could cause significant delays in shipments until we could shift the products from an affected facility or supplier to another facility or supplier. The manufacturing processes we rely on are specialized and are available from a limited number of suppliers. Alternate sources of manufacturing capacity, particularly wafer production capacity, may not be available to us on a timely basis. Even if alternate wafer production capacity is available, we may not be able to obtain it on favorable terms, or at all. Difficulties or delays in securing an adequate supply of our products on favorable terms, or at all, could impair our ability to meet our customers' requirements and have a material adverse effect on our operating results.

In addition, the highly complex and technologically demanding nature of semiconductor manufacturing has caused foundries from time to time to experience lower than anticipated manufacturing yields, particularly in connection



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with the introduction of new products and the installation and start-up of new process technologies. Lower than anticipated manufacturing yields may affect our ability to fulfill our customers' demands for our products on a timely basis. Moreover, lower than anticipated manufacturing yields may adversely affect our cost of goods sold and our results of operations.

***We may experience difficulties in transitioning to smaller geometry process technologies or in achieving higher levels of design integration, which may result in reduced manufacturing yields, delays in product deliveries and increased expenses.***

To remain competitive, we expect to continue to transition our semiconductor products to increasingly smaller line width geometries. This transition requires us to modify the manufacturing processes for our products and to redesign some products as well as standard cells and other integrated circuit designs that we may use in multiple products. We periodically evaluate the benefits, on a product-by-product basis, of migrating to smaller geometry process technologies to reduce our costs. Currently most of our products are manufactured in .35 micron, .25 micron, .18 micron, .15 micron, and .13 micron geometry processes. In addition, we expect to migrate some of our products to 90 nanometer process technology. In the past, we have experienced some difficulties in shifting to smaller geometry process technologies or new manufacturing processes, which resulted in reduced manufacturing yields, delays in product deliveries and increased expenses. We may face similar difficulties, delays and expenses as we continue to transition our products to smaller geometry processes. We are dependent on our relationships with our foundries to transition to smaller geometry processes successfully. We cannot assure you that our foundries will be able to effectively manage the transition or that we will be able to maintain our existing foundry relationships or develop new ones. If our foundries or we experience significant delays in this transition or fail to implement this transition efficiently, we could experience reduced manufacturing yields, delays in product deliveries and increased expenses, all of which could adversely affect our relationships with our customers and our results of operations. As smaller geometry processes become more prevalent, we expect to continue to integrate greater levels of functionality, as well as customer and third party intellectual property, into our products. However, we may not be able to achieve higher levels of design integration or deliver new integrated products on a timely basis, or at all. Moreover, even if we are able to achieve higher levels of design integration, such integration may have a short-term adverse impact on our operating results, as we may reduce our revenue by integrating the functionality of multiple chips into a single chip.

***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, we have engaged in litigation to enforce our intellectual property rights, to protect our trade secrets or to determine the validity and scope of proprietary rights of others, including our customers. We may engage in future litigation on similar grounds, which may require us to expend significant resources and to divert the efforts and attention of our management from our business operations. We cannot assure you that:

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

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

any of the measures described above would provide meaningful protection.

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

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

We and certain of our current and former officers and directors have been sued in several purported securities class action lawsuits, which have now been consolidated into a single action. We and certain of our directors and officers

have also been sued in purported shareholder derivative actions. Although we believe that these lawsuits are without

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merit, an adverse determination could have a negative impact on the price of our stock. Moreover, regardless of the ultimate result, the lawsuits may divert management's attention and resources from other matters, which could also adversely affect our business and results of operations.

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

Our former manufacturing operations used a variety of chemicals and were subject to a wide range of environmental protection regulations in the United States and Mexico. We have been designated as a potentially responsible party and are engaged in groundwater remediation at one Superfund site located at a former silicon wafer manufacturing facility and steel fabrication plant in Parker Ford, Pennsylvania formerly occupied by us. In addition, we are engaged in remediations of groundwater contamination at our former Newport Beach, California wafer fabrication facility. We currently estimate the remaining costs for these remediations to be approximately \$2.3 million and have accrued for these costs as of June 30, 2006.

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

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

As of June 30, 2006, we had approximately \$1.2 billion of U.S. Federal income tax net operating loss (NOL) carry forwards that can be used to offset taxable income in subsequent years. Approximately \$456.0 million of the NOL carry forwards were acquired in the merger with GlobespanVirata and other acquisitions. The NOL carry forwards are scheduled to expire at various dates through 2026. Section 382 of the Internal Revenue Code could limit the future use of some or all of the NOL carry forwards if the ownership of our common stock changes by more than 50 percentage points in certain circumstances over a three-year testing period. Based on information known to us, we have not undergone such a change of ownership and the merger did not constitute a change of ownership, although the shares of our common stock issued in the merger will be taken into account in any change of ownership computations. Direct or indirect transfers of our common stock, when taken together with the shift in ownership resulting from the merger, could result in a change of ownership that would trigger the Section 382 limitation. If such an ownership change occurs, Section 382 would limit our use of NOL carry forwards in each subsequent taxable year to an amount equal to a Federal long-term tax-exempt rate published by the Internal Revenue Service at the time of the ownership change, multiplied by our fair market value at such time; any unused annual limitation amounts may also be carried forward. The merger resulted in a change of ownership of GlobespanVirata and the future use of GlobespanVirata's NOL carry forwards is subject to the Section 382 limitation (or further limitation in the case of NOL carry forwards already subject to limitation as a result of previous transactions) based on the fair market value of GlobespanVirata at the time of the merger.

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

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

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

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

a prohibition on shareholder action by written consent;



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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, marketable equity securities, the Mindspeed warrant, short-term debt, and long-term debt. Our main investment objectives are the preservation of investment capital and the maximization of after-tax returns on our investment portfolio. Consequently, we invest with only high-credit-quality issuers and we limit the amount of our credit exposure to any one issuer. See also Part I, Item 7A, Quantitative and Qualitative Disclosures About Market Risk in our Annual Report on Form 10-K for the year ended September 30, 2005.

Our cash, cash equivalents and marketable debt securities are not subject to significant interest rate risk due to the short maturities of these instruments. As of June 30, 2006, the carrying value of our cash, cash equivalents and marketable debt securities approximates fair value.

As of June 30, 2006, our marketable equity securities consist of 6.2 million shares of Skyworks Solutions, Inc. Marketable equity securities are subject to equity price risk. For our equity security holdings, there are risks associated with the overall state of the stock market, having available buyers for shares we may sell, and ultimately being able to liquidate the securities at a favorable price. As of June 30, 2006, a 10% decrease in equity prices would result in a \$3.4 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, 2006, the carrying value of these securities included net unrealized losses of \$0.3 million.

We hold a warrant to purchase 30 million shares of common stock of Mindspeed Technologies, Inc. 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, 2006, a 10% decrease in the market price of Mindspeed's common stock would decrease the fair value of this warrant by approximately \$4.3 million. At June 30, 2006, the market price of Mindspeed's common stock was \$2.41 per share. For the quarter ended June 30, 2006, the market price of Mindspeed's common stock ranged from a low of \$2.26 per share to a high of \$4.37 per share.

Our short-term debt consists of borrowings under a 364-day credit facility. Interest related to our short-term debt is at the 7-day LIBOR plus 0.6% and was approximately 6.0% at June 30, 2006. Consequently, we do not believe our short-term debt is subject to significant market risk.

Our long-term debt consists of convertible subordinated notes with interest at fixed rates. 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, 2006:

<i>(in millions)</i>	<b>Carrying Value</b>	<b>Fair Value</b>
Cash and cash equivalents	\$ 225.5	\$ 225.5
Marketable debt securities	106.3	106.3
Marketable equity securities	34.1	34.1
Mindspeed warrant	29.3	29.3
Short-term debt	80.0	80.0
Current portion of long-term debt	456.5	449.7
Long-term debt	250.0	227.5

We transact business in various foreign currencies, and we have established a foreign currency hedging program utilizing foreign currency forward exchange contracts to hedge certain foreign currency transaction exposures. Under this program, from time to time, we offset foreign currency transaction gains and losses with gains and losses on the forward contracts, so as to mitigate our overall risk of foreign transaction gains and losses. We do not enter into forward contracts for speculative or trading purposes. At June 30, 2006, we had outstanding forward exchange contracts with a notional amount of 607.5 million Indian Rupees, approximately \$13.1 million, maturing at various dates through January 2007. Based on the fair value of these contracts at June 30, 2006, we recorded a net asset of \$0.1 million. Based on our overall currency rate exposure at June 30, 2006, a 10% change in the currency rates would

not have a material effect on our consolidated financial position, results of operations or cash flows.

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**ITEM 4. CONTROLS AND PROCEDURES**

Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation of our disclosure controls and procedures, as such term is defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act ), as of the end of the period covered by this report. Based on this evaluation, our principal executive officer and our principal financial officer concluded that our disclosure controls and procedures were effective.

As a result of the recent growth in our set top box business, management has implemented additional controls and procedures surrounding revenue recognition for sales to customers who have formal product testing and acceptance processes. There were no other changes in our internal control over financial reporting during the quarter ended June 30, 2006 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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

**Texas Instruments, Inc.** The Company's Conexant, Inc. subsidiary (formerly named GlobespanVirata, Inc.) was involved in a dispute with Texas Instruments, Inc., Stanford University and its Board of Trustees, and Stanford University OTL, LLC (collectively, Texas Instruments or TI) over a group of patents (and related foreign patents) that Texas Instruments alleged are essential to certain industry standards for implementing ADSL technology. Globespan commenced the litigation against TI in the spring of 2003, alleging that TI had violated the antitrust laws and had engaged in patent misuse with respect to their licensing of patents related to Asymmetric Digital Subscriber Line (ADSL) technology, and furthermore that TI had violated the antitrust laws by suppressing competition in ADSL technology (the Antitrust and Patent Misuse Claims). Globespan also alleged various violations of state law, including breach of contract, breach of the implied covenant of good faith and fair dealing, promissory estoppel, and tortious interference with prospective economic advantage (the State Law Claims). TI brought counterclaims against Globespan, alleging that it had infringed certain TI patents and owed money damages for that infringement. Among other defenses to those claims of patent infringement, Globespan asserted that the patents were unenforceable because of patent misuse and furthermore that it was licensed to these patents under a license agreement between Conexant and TI, as of the date that Globespan merged into Conexant.

In the litigation, the District Court in New Jersey previously bifurcated the Antitrust and Patent Misuse Claims and the State Law Claims brought by Globespan and the patent counterclaims brought by TI, and directed that the patent issues asserted by TI would be tried first, with the antitrust and patent misuse claims asserted by Globespan to be tried second. Trial of the patent issues was conducted during January 2006 and into early February 2006. On February 6, 2006, the jury rendered a verdict finding that Globespan had infringed three patents and that its infringement was willful. The jury awarded lost profits damages to TI of \$60.5 million and reasonable royalty damages to TI of \$51.5 million, for a total verdict of \$112.0 million. As an alternative to the \$112.0 million verdict, the jury was also instructed to provide a damages award through March 1, 2004 (roughly the effective date for Globespan's argument that it was licensed under the Conexant-TI license agreement). For the period through March 1, 2004, the jury awarded lost profits damages to TI of \$52.0 million and reasonable royalty damages of \$45.0 million for a total of \$97.0 million. TI also sought an award of prejudgment interest on any damages finally awarded.

At the conclusion of the patent infringement phase of the trial, the district judge declined to enter a judgment with respect to this jury verdict. This was because a second phase of this case remained to be tried—the Antitrust and Patent Misuse Claims and State Law Claims asserted by Globespan against TI. Trial of that second phase was scheduled for October 2006. Thus, at that stage, there was no enforceable judgment against Globespan. If Globespan were to subsequently prevail on its Antitrust and Patent Misuse Claims in the subsequent phase of the litigation, the patent damages award to TI would have been barred in whole or in substantial part, and Globespan could have been entitled to the recovery of damages and attorneys' fees from TI if it had prevailed on its Antitrust and Patent Misuse Claims and/or its State Law Claims.

On March 3, 2006 the District Court issued an order granting TI's motion to dismiss certain of Globespan's antitrust claims. The court dismissed four counts of Globespan's complaint relating to certain defined ADSL markets. The court also dismissed Globespan's claims alleging that TI's patent licensing practices constituted per se unlawful tying under the antitrust laws.

On May 5, 2006, the Company announced that it had reached a definitive agreement with TI that settles all aspects of this dispute. Under the terms of the settlement agreement, the Company made a lump-sum payment of \$70.0 million to TI during the three months ended June 30, 2006 (see Note 7). The agreement resolves the alleged past infringement of ADSL patents by GlobespanVirata products and provides a fully paid-up, going-forward license for these products under a previously existing 2003 agreement between the Company and TI. In addition, the Company's patent license with TI was amended to make it clear that the previous agreement extends to all xDSL products.

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***Class Action Suits*** In December 2004 and January 2005, the Company and certain current and former officers and directors were named as defendants in several complaints seeking monetary damages filed on behalf of all persons who purchased Company common stock during a specified class period. These suits were filed in the U.S. District Court of New Jersey (New Jersey cases) and the U.S. District Court for the Central District of California (California cases), alleging that the defendants violated the Securities Exchange Act of 1934 by allegedly disseminating materially false and misleading statements and/or concealing material adverse facts. The California cases were consolidated with the New Jersey cases so that all of the class action suits, now known as *Witriol v. Conexant, et al.*, are being heard in the U.S. District Court of New Jersey by the same judge. The defendants believe these charges are without merit and intend to vigorously defend the litigation. On September 1, 2005, the defendants filed their motion to dismiss the case. On November 23, 2005, the court granted the plaintiff's motion to file a second amended complaint, which was filed on December 5, 2005. The defendants filed an amended motion to dismiss the case on February 6, 2006. Plaintiffs filed their opposition on April 24, 2006, and defendant's reply was filed on June 14, 2006.

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**ITEM 6. EXHIBITS**

<b>Exhibit No.</b>	<b>Description</b>
10.1	Separation and Release Agreement, dated as of July 5, 2006, by and between the Company and F. Matthew Rhodes, filed as Exhibit 99.1 to the Company's Current Report on Form 8-K filed on July 7, 2006, is incorporated by reference.
31.1	Certification of the Chief Executive Officer of Periodic Report Pursuant to Rule 13a-15(e) or 15d-15(e).
31.2	Certification of the Chief Financial Officer of Periodic Report Pursuant to Rule 13a-15(e) or 15d-15(e).
32	Certification by Chief Executive Officer and Chief Financial Officer of Periodic Report Pursuant to 18 U.S.C. Section 1350.

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**SIGNATURE**

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

CONEXANT SYSTEMS, INC.  
(Registrant)

Date: August 9, 2006

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

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