ATHEROS COMMUNICATIONS INC
Form 10-Q
May 16, 2005
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2005

OR

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

For the transition period from ______ to ______

Commission File No. 0-50534

ATHEROS COMMUNICATIONS, INC.

(Exact name of registrant as specified in its charter)

Delaware	**77-0485570**
(State or other jurisdiction of	**(I.R.S. Employer**
incorporation or organization)	**Identification No.)**

529 Almanor Avenue, Sunnyvale, CA 94085-3512

(Address of principal executive offices, Zip Code)

(408) 773-5200

(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 x No ¨

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No x

As of May 12, 2005, 48,974,139 shares of Common Stock, par value $0.0005, were issued and outstanding.

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QUARTERLY REPORT ON FORM 10-Q

FOR THE QUARTER ENDED MARCH 31, 2005

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PART I: FINANCIAL INFORMATION

Item 1. ***Financial Statements***

ATHEROS COMMUNICATIONS, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands)

(Unaudited)

	March 31, 2005	December 31, 2004
ASSETS		
Current assets:		
Cash and cash equivalents	$ 43,995	$ 32,971
Marketable securities	114,897	121,514
Accounts receivable, net	28,007	29,750
Inventory	17,930	15,215
Prepaid expenses and other current assets	5,770	3,611
Total current assets	210,599	203,061
Property and equipment, net	2,761	2,757
Other assets	514	545
Total assets	$ 213,874	$ 206,363
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 15,724	$ 11,172
Deferred revenue	1,544	1,224
Other accrued liabilities	20,306	20,626
Total current liabilities	37,574	33,022
Other long-term liabilities	423	301
Commitments and contingencies		
Stockholders equity:		
Common stock	250,223	249,631
Deferred stock-based compensation	(1,608)	(2,484)
Accumulated deficit	(72,098)	(73,767)
Accumulated other comprehensive loss	(640)	(340)
Total stockholders equity	175,877	173,040

Total liabilities and stockholders equity	$ 213,874	$ 206,363

The accompanying notes are an integral part of these condensed consolidated financial statements.

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ATHEROS COMMUNICATIONS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share data)

(Unaudited)

	Three Months Ended March 31,	
	2005	**2004**
Net revenue	$ 41,233	$ 43,099
Cost of goods sold (1)	22,867	24,068
Gross profit	18,366	19,031
Operating expenses:		
Research and development (1)	10,764	9,725
Sales and marketing (1)	4,008	3,501
General and administrative (1)	2,149	2,230
Stock-based compensation	454	1,116
Total operating expenses	17,375	16,572
Income from operations	991	2,459
Interest income, net	972	153
Income before income taxes	1,963	2,612
Provision for income taxes	294	233
Net income	$ 1,669	$ 2,379
Basic net income per share	$ 0.03	$ 0.08
Shares used in computing basic net income per share	48,091	30,774
Diluted net income per share	$ 0.03	$ 0.05
Shares used in computing diluted net income per share	53,830	48,230

(1) Amounts exclude stock-based compensation, as follows:

Cost of goods sold	$ 26	$ 75
Research and development	168	364
Sales and marketing	88	257

General and administrative	171	420
	$ 454	$ 1,116

The accompanying notes are an integral part of these condensed consolidated financial statements.

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ATHEROS COMMUNICATIONS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(Unaudited)

	Three Months Ended March 31,	
	2005	**2004**
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 1,669	$ 2,379
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	365	465
Amortization of deferred stock-based compensation	454	1,116
Tax benefit on employee stock transactions	64	
Change in assets and liabilities:		
Accounts receivable	1,743	(2,620)
Inventory	(2,715)	(3,834)
Prepaid expenses and other current assets	(2,110)	(800)
Accounts payable	4,552	1,699
Deferred revenue	445	1,184
Other accrued liabilities	(294)	2,460
Net cash provided by operating activities	4,173	2,049
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of property and equipment	(367)	(656)
Purchase of marketable securities	(23,187)	(36,525)
Maturities of marketable securities	29,504	12,894
Other assets	(20)	602
Net cash provided by (used in) investing activities	5,930	(23,685)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Issuance of common stock	950	133,526
Repurchase of common stock		(8)
Repayment of short-term borrowings		(4,000)
Repayment of debt and capital lease obligations	(29)	(2,157)
Net cash provided by financing activities	921	127,361
NET INCREASE IN CASH AND CASH EQUIVALENTS	11,024	105,725
CASH AND CASH EQUIVALENTS, Beginning of period	32,971	13,615
CASH AND CASH EQUIVALENTS, End of period	$ 43,995	$ 119,340

The accompanying notes are an integral part of these condensed consolidated financial statements.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. Organization and Basis of Presentation

Organization Atheros Communications, Inc. (the Company) was incorporated in May 1998 in the state of Delaware and commenced operations in December 1998. The Company is a developer of semiconductor system solutions for wireless communications products.

Basis of Presentation and Use of Estimates The accompanying unaudited Condensed Consolidated Financial Statements have been prepared in accordance with accounting principles generally accepted in the United States of America (US GAAP) related to interim financial statements based on applicable Securities and Exchange Commission (the SEC) rules and regulations. Accordingly, they do not include all of the information and footnotes required by US GAAP for complete financial statements. This financial information reflects all adjustments, which are, in the opinion of the Company, of a normal and recurring nature and necessary to present fairly the statements of financial position, results of operations and cash flows for the dates and periods presented. The December 31, 2004 balance sheet was derived from audited financial statements as of that date. All significant intercompany transactions and balances have been eliminated.

The preparation of financial statements in conformity with US GAAP requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of expenses during the reporting period. Actual results may differ from these estimates.

These Condensed Consolidated Financial Statements should be read in conjunction with the Company s audited consolidated financial statements for the fiscal year ended December 31, 2004 included in its annual report on Form 10-K, as filed on March 11, 2005 with the SEC. The results of operations for the three months ended March 31, 2005 are not necessarily indicative of the results to be expected for any future periods.

2. Comprehensive Income

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

	Three Months Ended March 31,	
	2005	**2004**
Net income	$ 1,669	$ 2,379
Other comprehensive loss:		
Change in unrealized loss on investments	(300)	

Total comprehensive income	$ 1,369	$ 2,379

3. Significant Accounting Policies

The Company s significant accounting policies are disclosed in its audited consolidated financial statements for the year ended December 31, 2004. The Company s significant accounting policies have not changed during the three months ended March 31, 2005.

Stock-Based Compensation The Company accounts for stock-based compensation to employees in accordance with the provisions of Accounting Principles Board Opinion (APB) No. 25, *Accounting for Stock Issued to Employees*, and complies with the disclosure provisions of Statement of Financial Accounting Standards (SFAS) No. 123, *Accounting for Stock-Based Compensation*, as amended by SFAS No. 148, *Accounting for Stock-Based Compensation Transition and Disclosures*. The Company accounts for equity instruments issued to nonemployees in accordance with the provisions of SFAS No. 123 and Emerging Issues Task Force (EITF) No. 96-18, *Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Connection with Selling, Goods or Services*, which requires that the fair value of such instruments be recognized as an expense over the period in which the related services are provided. Such expenses are measured using the value of the equity instruments issued, as this is more readily determinable than the fair value of the services received.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The Company amortizes deferred stock-based compensation using the graded vesting method over the vesting periods of the stock options, generally four to five years. The graded vesting method provides for vesting of portions of the overall awards at interim dates and results in accelerated vesting as compared to the straight-line method. Had compensation expense been determined based on the fair value at the grant date for all employee awards, consistent with the provisions of SFAS No. 123, the Company s pro forma net income and net income per share would have been as follows (in thousands, except per share data):

	Three Months Ended March 31,	
	2005	2004
Net income as reported	$ 1,669	$ 2,379
Add: total stock-based employee compensation included in reported net income	454	1,116
Less: total stock-based compensation determined under the fair value based method for all awards	(2,012)	(1,767)
Pro forma net income	$ 111	$ 1,728
Basic net income per share as reported	$ 0.03	$ 0.08
Diluted net income per share as reported	$ 0.03	$ 0.05
Pro forma basic net income per share	$ 0.00	$ 0.06
Pro forma diluted net income per share	$ 0.00	$ 0.04

Through November 26, 2003, the date of the Company s initial filing with the SEC related to its initial public offering, the Company used Black-Scholes valuation model assuming no volatility (minimum value method) to estimate the fair value of options granted to employees. Options granted subsequent to November 26, 2003 were valued using the Black-Scholes valuation model, with volatility assumptions as discussed below. The fair value of the Company s stock-based awards to employees was estimated using the following weighted-average assumptions:

	Three Months Ended March 31,	
	2005	2004
Estimated life (in years)	4.0	4.7
Risk-free interest rate	3.6%	3.2%
Expected dividends		
Volatility	64%	80%

Due to the subjective nature of the assumptions used in the Black-Scholes model, the pro forma net income and net income per share disclosures may not reflect the associated fair value of the outstanding options.

Because the Company s common stock had recently become publicly traded, its historical data on the volatility of its common stock as of March 31, 2004 was limited. Therefore, the Company estimated volatility based on the average volatilities of similar entities. For the period ended March 31, 2005, the Company estimated volatility based on considerations of the implied volatility of similar options traded on the open market and the average volatilities of similar entities.

Product Warranty The Company generally provides a warranty on its products for a period of one year, however, it may be greater for certain customers. Accordingly, the Company provides for the warranty costs at the time of sale based on historical activity. The determination of such provisions requires the Company to make estimates of product return rates and expected costs to repair or replace the products under warranty. If the actual return rates and/or repair and replacement costs differ significantly from these estimates, adjustments to cost of sales may be required in future periods. Components of the accrual for warranty costs are as follows (in thousands):

	Three Months Ended March 31,	
	2005	**2004**
Beginning balance	$ 1,023	$ 578
Additions related to current period sales	399	322
Warranty costs incurred in the current period	(99)	(6)
Adjustments to accruals related to prior period sales	(193)	(66)
Ending balance	$ 1,130	$ 828

4. Inventory

Inventory consists of (in thousands):

	March 31, 2005	**December 31, 2004**
Finished goods	$ 5,433	$ 4,442
Work-in-process	10,211	8,283
Raw materials	2,286	2,490
Total	$ 17,930	$ 15,215

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

5. Accrued Liabilities

Accrued liabilities consist of (in thousands):

	March 31, 2005	December 31, 2004
Accrued customer incentives	$ 10,013	$ 10,388
Accrued compensation and benefits	3,535	3,923
Other liabilities	6,758	6,315
Total	$ 20,306	$ 20,626

6. Short and Long-Term Debt

Bank Loan and Security Agreement

In March 2005, the Company amended its existing loan agreement (the Agreement) with a bank. The Agreement allows the Company to finance up to $10,000,000 of working capital requirements. Borrowings under the Agreement are secured by all of the tangible assets of the Company. The Agreement contains financial covenants related to cash and cash equivalents and marketable securities on hand, as well as other non-financial covenants. As of March 31, 2005, the Company was in compliance with all required covenants. Interest on borrowings under the working capital line is payable monthly and is calculated at the bank s prime rate (5.75% at March 31, 2005). Borrowings under the line are due in March 2006, or earlier as required by borrowing limits defined in the Agreement. No balances were outstanding as of March 31, 2005 under the agreement.

7. Net Income Per Share

Net income per share is calculated as follows (in thousands, except per share data):

	Three Months Ended March 31,	
	2005	2004

Net income (numerator)	$ 1,669	$ 2,379
Denominator for basic net income per share:		
Weighted average shares outstanding	48,241	31,260
Weighted average shares subject to repurchase	(150)	(486)
Shares used to calculate basic net income per share	48,091	30,774
Effect of dilutive securities:		
Common stock options and warrants	5,589	6,323
Shares subject to repurchase	150	486
Convertible preferred stock		10,647
Shares used to calculate diluted net income per share	53,830	48,230
Basic net income per share	$ 0.03	$ 0.08
Diluted net income per share	$ 0.03	$ 0.05

The Company excludes potentially dilutive securities from its diluted net income per share calculation when their effect would be antidilutive to net income per share amounts. The common stock equivalents related to options to purchase 349,000 and 23,000 shares of the Company s common stock were excluded from the net income per share calculation in the periods ended March 31, 2005 and 2004, respectively, as their effect would have been antidilutive.

8. Segment Information, Operations by Geographic Area and Significant Customers

The Company currently operates in one reportable segment, the design and marketing of semiconductors for the wireless industry. The Company s Chief Operating Decision Maker is the CEO.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Geographic Information

Long-lived assets outside of the United States are insignificant. Net revenue consists of sales to customers in the following countries:

	Three Months Ended March 31,	
	2005	2004
Taiwan	78%	90%
United States	5	1
Other	17	9

Significant Customers

Customers representing greater than 10% of net revenue are as follows:

	Three Months Ended March 31,	
	2005	2004
Cameo Communications, Inc.	21%	*
Hon-Hai Precision Industry (formerly Ambit Microsystems Corporation)	17	33%
Alpha Networks, Inc.	13	11
Askey Computer Corporation	10	16

Customers representing greater than 10% of net accounts receivable are as follows:

	March 31, 2005	December 31, 2004
Cameo Communications, Inc.	24%	11%
Askey Computer Corporation	12	25
Alpha Networks, Inc.	12	12
Hon-Hai Precision Industry (formerly Ambit Microsystems Corporation)	*	13
Gemtek Technology Co., Ltd	*	11

* less than 10% in the applicable period.

9. Recent Accounting Pronouncements

In March 2004, the Financial Accounting Standards Board, or FASB, reached a consensus on EITF Issue No. 03-01, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments,* which provides new guidance for assessing impairment losses on investments. Additionally, EITF 03-01 includes new disclosure requirements for investments that are deemed to be temporarily impaired. In September 2004, the FASB delayed the effective date of the recognition and measurement provisions of EITF 03-01. The Company will evaluate the impact of EITF 03-01 once final guidance is issued.

In December 2004, the FASB issued SFAS No. 153, *Exchanges of Nonmonetary Assets An Amendment of APB Opinion No. 29.* APB Opinion No. 29, *Accounting For Nonmonetary Transactions*, is based on the opinion that exchanges of nonmonetary assets should be measured based on the fair value of the assets exchanged. SFAS No. 153 amends Opinion No. 29 to eliminate the exception for nonmonetary exchanges of similar productive assets and replaces it with a general exception for exchanges of nonmonetary assets whose results are not expected to significantly change the future cash flows of the entity. The provisions of this Statement are effective for nonmonetary asset exchanges occurring in fiscal periods beginning after June 15, 2005. The adoption of SFAS No. 153 is not expected to have any impact on the Company s consolidated financial condition or results of operations.

The Company accounts for stock-based compensation awards issued to employees using the intrinsic value measurement provisions of APB Opinion No. 25, *Accounting for Stock Issued to Employees*. Accordingly, no compensation expense has been recorded for stock options granted with exercise prices greater than or equal to the fair value of the underlying common stock at the option grant date. On December 16, 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment,* or SFAS 123R. SFAS 123R eliminates the alternative of applying the intrinsic value measurement provisions of Opinion 25 to stock compensation awards issued to employees. Rather, the new standard requires enterprises to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award. That cost will be recognized over the period during which an employee is required to provide services in exchange for the award, known as the requisite service period.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The Company has not yet quantified the effects of the adoption of SFAS 123R, but it is expected that the new standard will result in significant stock-based compensation expense. The pro forma effects on net results of operations and earnings per share if the Company had applied the fair value recognition provisions of original SFAS 123 on stock compensation awards (rather than applying the intrinsic value measurement provisions of Opinion 25) are disclosed above. Although such pro forma effects of applying original SFAS 123 may be indicative of the effects of adopting SFAS 123R, these pro forma effects should not be relied upon in determining the effects on net results of operations of adopting SFAS 123R as the provisions of these two statements differ in some important respects. The actual effects of adopting SFAS 123R will be dependent on numerous factors including, but not limited to, the valuation model chosen by us to value stock-based awards; the assumed award forfeiture rate; the accounting policies adopted concerning the method of recognizing the fair value of awards over the requisite service period; and the transition method chosen for adopting SFAS 123R.

In April 2005, the effective date of SFAS 123R was deferred to the Company s fiscal quarter beginning January 1, 2006. SFAS 123R requires the use of the Modified Prospective Application Method. Under this method SFAS 123R is applied to new awards and to awards modified, repurchased, or cancelled after the effective date. Additionally, compensation cost for the portion of awards for which the requisite service has not been rendered, such as unvested options, that are outstanding as of the date of adoption shall be recognized as the remaining requisite services are rendered. The compensation cost relating to unvested awards at the date of adoption shall be based on the grant-date fair value of those awards as calculated for pro forma disclosures under the original SFAS 123. In addition, companies may use the Modified Retrospective Application Method. This method may be applied to all prior years for which the original SFAS 123 was effective or only to prior interim periods in the year of initial adoption. If the Modified Retrospective Application Method is applied, financial statements for prior periods shall be adjusted to give effect to the fair-value-based method of accounting for awards on a consistent basis with the pro forma disclosures required for those periods under the original SFAS 123.

10. Subsequent Events

In April 2005, the Company entered into an operating lease agreement related to a new headquarters facility in Santa Clara, California. The initial term of the lease is 61 months commencing in June 2005. Future minimum lease payments under the operating lease are $5.8 million.

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Item 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion of our financial condition and results of operations should be read together with the financial statements and related notes that are included elsewhere in this quarterly report. This report on Form 10-Q contains forward-looking statements, including, but not limited to, statements about our expectations regarding our average selling prices, the growth of our business, the market for our products and our market share, our strategy regarding new markets, our customer concentration, our participation in wireless standards bodies and the effects of the adoption of standards, our future office space needs, our revenue and sources of revenue, our sales and revenue to customers in Asia, our anticipated volume shipments of PHS chips, our expenses and cost of goods sold, our accounts receivable balance, our anticipated cash needs, our anticipated capital expenditures and capital requirements, the adequacy of our capital resources, our needs for additional financing, our intellectual property, market risk sensitive instruments, potential legal proceedings, our critical accounting policies and estimates, and the expected impact of various accounting policies and rules adopted by the Financial Accounting Standards Board. These statements may be identified by such terms as anticipate, will, expect, may, might, intend, could, can, or the negative of those terms or similar expressi to identify forward-looking statements. These forward-looking statements are subject to risks and uncertainties that may cause actual results to differ materially from those expressed or implied by the forward-looking statements. These risks and uncertainties include, but are not limited to, the factors affecting our quarterly results, our ability to manage our growth, our ability to sustain or increase profitability, demand for our chipsets, the effect of declines in average selling prices for our products, our ability to compete in new and existing markets and other risks discussed in Management s Discussion and Analysis of Financial Condition and Results of Operations Factors That May Affect Our Results in this report. These forward-looking statements represent our estimates and assumptions only as of the date of this report. Unless required by law, we undertake no responsibility to update these forward-looking statements.

Overview

We are a leading developer of semiconductor system solutions for wireless communications products. We combine our wireless systems expertise with high-performance radio frequency, or RF, mixed signal and digital semiconductor design skills to provide highly integrated chipsets that are manufacturable on low-cost, standard complementary metal-oxide semiconductor, or CMOS, processes.

We provide a comprehensive portfolio of multi-chip and single chip products ranging from entry-level wireless networking products for the home and small office markets to sophisticated wireless infrastructure systems-on-chip with advanced network management capabilities for the enterprise market. Our wireless systems solutions are used in a variety of applications in the personal computer, enterprise access, small office and branch office networking, home networking, hotspot, wireless broadband, voice, mobile computing devices, and consumer electronics markets supporting the Institute of Electrical and Electronics Engineers, or IEEE, family of wireless local area networking, or WLAN, standards, including the 802.11b, 802.11g and 802.11a standards. We have a broad base of leading personal computer original equipment manufacturer, or PC OEM, customers, including Fujitsu, Hewlett-Packard, IBM, NEC, and Toshiba, consumer electronics customers, including Philips and Siemens, and networking equipment manufacturers, including Cisco Systems, D-Link, and NETGEAR.

In addition, in March 2005, we announced our first cellular solution for Personal Handyphone Systems, or PHS, consisting of a single chip that implements a complete cellular transceiver, baseband, application processor, audio paths, power management, keyboard, speaker and display interfaces. PHS, which is widely deployed in China, Japan and Taiwan, is an advanced Time Division Multiple Access-Time Division Duplex, or TDMA-TDD, technology operating at 1.9 GHz providing high quality voice, advanced data services and long battery life. We have not yet begun volume shipments of our PHS chips, but anticipate doing so in the second half of 2005.

Net Revenue. Our revenue is derived primarily from the sale of WLAN chipset products and, to a lesser extent, from licensed software and services. Our sales have historically been made on the basis of purchase orders rather than long-term agreements. Original equipment manufacturers, or OEMs, utilize our chipsets in developing their wireless system solutions such as access point, cardbus and integrated client card products. Some OEMs directly purchase chipsets from us and manufacture their products. Other OEMs utilize original design manufacturers, or ODMs, to design and build subsystem products that the OEM then purchases from the ODM and incorporates into the OEM s wireless system solution. Accordingly, we ship our products either directly to the OEM or to the ODM based on the requirements of each OEM. Purchase orders are received from an OEM or an ODM and we generally recognize revenue based on the shipment of chipsets to this customer. A single ODM may provide products based on our chipsets to numerous OEMs. However, we attempt to maintain a close relationship with the target OEM to monitor end-market demand. Due to the use of ODMs, our direct customer base is relatively concentrated, although we believe that the number of total OEMs who purchase our chipsets through ODMs is broader. We anticipate that we may continue to experience changes in our ODM customer base as our end customers change ODMs for a variety of reasons while still using our chipsets.

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We provide customer incentives to some of our direct and indirect customers. These obligations are estimated and recorded as a reduction of revenue at the time at which we ship product to the customers. Estimating incentive amounts requires that we make estimates regarding the percentage of committed incentives that will be submitted by our customers and the value of the incentives at the time of redemption. These estimates may require revisions at later dates if the actual sales data submitted by the customers differs significantly from the original estimates, which may have the effect of increasing or decreasing net revenue in particular periods.

In the three months ended March 31, 2005, Cameo Communications, Inc., Hon-Hai Precision Industry, Alpha Networks, Inc. and Askey Computer Corporation accounted for 21%, 17%, 13% and 10% of our net revenue, respectively. In the three months ended March 31, 2004, Hon-Hai Precision Industry (formerly Ambit Microsystems), Askey Computer Corporation and Alpha Networks, Inc. accounted for 33%, 16% and 11% of our net revenue, respectively. We expect to continue to have major concentrations of sales to a relatively small list of ODM customers.

Substantially all of our sales are to customers outside the United States and Canada. Sales to customers in Asia accounted for 95% and 99% of net revenue for the three months ending March 31, 2005 and 2004, respectively. Because many of our ODM customers are located in Asia, we anticipate that a majority of our revenue will continue to be represented by sales to customers in that region. Although a large percentage of our sales are made to customers in Asia, we believe that a significant number of the systems designed by these customers are then sold through to OEMs outside of Asia. All of our sales are denominated in United States dollars.

Cost of Goods Sold. Cost of goods sold relates primarily to the purchase of silicon wafers, costs associated with assembly, test and inbound and outbound shipping of our chipsets, costs of personnel, materials and occupancy associated with manufacturing support and quality assurance, royalty costs and adjustments to state inventory at the lower of cost or market caused by product obsolescence and transitions from older to newer products. Additionally, our cost of goods sold includes accruals for warranty obligations, which we record when revenue is recognized. Because we do not have long-term, fixed supply agreements, our wafer costs are subject to changes based on the cyclical demand for semiconductors. In addition, after we purchase wafers from foundries, we are subject to yield risk related to manufacturing these wafers into finished goods.

Research and Development. Research and development expense relates primarily to compensation and associated costs related to development employees and contractors, mask and reticle costs, prototype wafers, software and computer-aided design software licenses, intellectual property license costs, reference design development costs, development testing and evaluation, occupancy costs and depreciation expense. All research and development costs are expensed as incurred. We expect our research and development costs to increase in absolute dollars as we invest to develop new products to be competitive and address new markets in the future.

Sales and Marketing. Sales and marketing expense relates primarily to compensation and associated costs for marketing and selling personnel, sales commissions to independent sales representatives, public relations, promotional and other marketing expenses, travel, trade show expenses, depreciation expenses and allocated occupancy costs. We expect sales and marketing expenses will increase in absolute dollars as we hire additional personnel and expand our sales and marketing efforts.

General and Administrative. General and administrative expense relates primarily to compensation and associated costs for general and administrative personnel, professional fees and banking fees, charges related to allowance for doubtful accounts and allocated occupancy costs. We expect that general and administrative expense will increase in absolute dollars as we hire additional personnel and incur costs related to the anticipated growth of our business, compliance with the requirements of the Sarbanes-Oxley Act of 2002 and improvements to our information technology infrastructure.

Stock-Based Compensation. In connection with the grant of stock options in 2001, 2002 and 2003, we have recorded an aggregate of $8.7 million in stock-based compensation through March 31, 2005. These options were considered compensatory because the fair market value of our stock on the date of grant was greater than the exercise price. As of March 31, 2005, we had an aggregate of $1.6 million in stock-based compensation remaining to be amortized. We are amortizing deferred stock-based compensation over the vesting period of the related option and warrant, which is generally four to five years using the graded vesting method. This deferred stock-based compensation balance will be amortized as follows, assuming no forfeiture of awards: $846,000 during the remaining three quarters of 2005; $586,000 during 2006; $164,000 during 2007; and $12,000 during 2008.

Interest Income, Net. Interest income consists of interest earned on cash and cash equivalents and marketable securities balances. Interest expense consists of interest on our revolving line of credit and equipment loans.

Provision for Income Taxes. Provision for income tax relates primarily to US alternative minimum tax due to the utilization of net operating loss carryforwards and non-US foreign taxes on our income.

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Critical Accounting Policies and Estimates

Our discussion and analysis of our financial condition and the results of operations are based on our financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue and expenses. We base our estimates on historical experience and on various other assumptions 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. Actual results may differ from these estimates under different assumptions or conditions. Our critical accounting policies are set forth below.

Revenue Recognition. We derive revenue primarily from three sources:

- the sale of our wireless chipsets and reference designs;
- our licensed software and technical documentation; and
- service and support revenue

We recognize revenue in accordance with SEC Staff Accounting Bulletin (SAB) No. 104, *Revenue Recognition*. SAB 104 requires that four basic criteria must be met before revenue can be recognized: (1) persuasive evidence of an arrangement exists; (2) delivery has occurred or services have been rendered; (3) the fee is fixed and determinable; and (4) collectibility is reasonably assured. Determination of criteria (3) and (4) are based on management s judgment regarding the fixed nature of the fee charged for the products delivered and the collectibility of those fees. Should changes in conditions cause management to determine these criteria are not met for certain future transactions, revenue recognized for any reporting period could be adversely impacted.

We provide customer incentives to some of our direct and indirect customers. These obligations are estimated and recorded as a reduction of revenue at the time at which we ship product to the customers in accordance with Emerging Issues Task Force Issue No. 01-09, Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor s Products). Estimated incentive amounts are recorded as a reduction of revenue and are based on agreements between the company and our customers. Estimating incentive amounts requires that we make estimates regarding the percentage of committed incentives that will be submitted by our customers and the value of the incentives at the time of redemption. These estimates may require revisions at later dates if the actual claims submitted by the customers differs significantly from the original estimates, which may have the effect of increasing or decreasing net revenue and gross profit as a percentage of revenue in a particular period.

Inventory. We continually assess the recoverability of our inventory based on assumptions about demand and market conditions. Forecasted demand is determined based on historical sales and expected future sales. We value our inventory at the lower of actual cost (using the first-in, first-out method) or its current estimated market value. We adjust our inventory to the estimated lower of cost or market value to account for its obsolescence or lack of marketability. Adjustments are calculated as the difference between the cost of inventory and the estimated market value based upon assumptions about future demand and market conditions. If actual market conditions are less favorable than those projected by management, additional inventory write-downs may be required that may adversely affect our operating results. If actual market conditions are more favorable, we may have higher gross margins when products are sold.

Stock Options. We have elected to follow the intrinsic value-based method prescribed by Accounting Principles Board Opinion 25, *Accounting for Stock Issued to Employees*, or APB 25, and related interpretations in accounting for employee stock options rather than adopting the alternative fair value accounting provided under Statement of Financial Accounting Standards, or SFAS, No. 123, *Accounting for Stock Based Compensation*. Therefore, we do not record any compensation expense for stock options we grant to our employees where the exercise price equals the fair market value of the stock on the date of grant and the exercise price, number of shares eligible for issuance under the options and vesting period are fixed. We comply with the disclosure requirements of SFAS No. 123 and SFAS No. 148, *Accounting for Stock-Based Compensation Transition and Disclosures*, which require that we disclose our pro forma net income and net income per common share as if we had expensed the fair value of the options. In calculating such fair value, there are certain assumptions that we use, as disclosed in note 3 of our unaudited condensed financial statements.

Accounts Receivable Allowance. We perform ongoing credit evaluations of our customers and adjust credit limits and their credit worthiness, as determined by our review of current credit information. We continuously monitor collections and payments from our customers and maintain an allowance for doubtful accounts based upon our historical experience, our anticipation of uncollectible accounts receivable and any specific customer collection issues that we have identified. While our credit losses have historically been within our expectations and the allowance established, we might not continue to experience the same credit loss rates that we have in the past. Our receivables are concentrated in a relatively few number of customers. Therefore, a significant change in the liquidity or financial position of any one customer could make collection of our accounts receivable more difficult, require us to increase our allowance for doubtful accounts and negatively affect our working capital.

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Product Warranty Accrual. We provide for the estimated cost of product warranties at the time revenue is recognized. While we engage in extensive product quality programs and processes, including actively monitoring and evaluating the quality of our chipset suppliers, our warranty obligation is affected by product failure rates, the cost of replacement chipsets and inbound and outbound freight costs incurred in replacing a chipset after failure. We continuously monitor chipset returns for warranty and maintain an accrual for the related warranty expenses based on historical experience of similar products as well as various other assumptions that we believe to be reasonable under the circumstances. Should actual failure rates, cost of chipset replacement and inbound and outbound freight costs differ from our estimates, revisions to the estimated warranty accrual would be required.

Results of Operations

The following table shows the percentage relationships of the listed items from our consolidated statements of operations, as a percentage of net revenue for the periods indicated.

	Three Months Ended March 31,	
	2005	**2004**
Consolidated Statements of Operations Data:		
Net revenue	100%	100%
Cost of goods sold	55	56
Gross profit	45	44
Operating expenses:		
Research and development	26	23
Sales and marketing	10	8
General and administrative	5	5
Stock-based compensation	1	2
Total operating expenses	42	38
Income from operations	3	6
Interest income, net	2	1
Provision for income taxes	(1)	(1)
Net income	4%	6%

Comparison of Three Months Ended March 31, 2005 to Three Months Ended March 31, 2004

(tables presented in thousands, except percentage amounts)

Net Revenue

	Three Months Ended March 31,		
	2005	2004	% Change in 2005
Net revenue	$ 41,233	$ 43,099	(4)%

The decrease in net revenue for the three months ended March 31, 2005 as compared to the same period in 2004 was due to lower average selling prices of our chipsets as we competitively priced our chipsets to aggressively pursue market opportunities, and to increased shipments of our single chip solutions which we began shipping in the second quarter of 2004. Our single chip solutions are generally priced lower than the combined average selling prices of our multi-chip solutions. As a result, net revenue decreased while the total number of chipsets shipped increased from approximately 3.2 million in the first quarter of 2004 to approximately 4.7 million for the comparable period in 2005.

Gross Profit

	Three Months Ended March 31,		
	2005	2004	% Change in 2005
Gross profit	$ 18,366	$ 19,031	(3)%
% of net revenue	45%	44%	

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Gross profit as a percentage of revenue in the three months ended March 31, 2005 increased slightly as compared to gross profit as a percentage of revenue in the comparable period of 2004. Gross profit as a percentage of revenue in the first quarter of 2005 was favorably impacted by a reduction of estimated customer incentives recorded in previous periods, partially offset by decreases in average selling prices. We expect our gross margins will decline in the second fiscal quarter of 2005 due to anticipated product mix changes and decreases in average selling prices. During the first quarter in 2005 and 2004, software license fee revenue contributed 0.5% and 0.6%, respectively, to our gross margin.

Research and Development

	Three Months Ended March 31,		% Change in
	2005	2004	2005
Research and development	$ 10,764	$ 9,725	11%
% of net revenue	26%	23%	

The increase in research and development expenses was primarily due to increased compensation costs of $873,000 to support a 21% increase in the number of research and development personnel. Additionally, prototype costs, mask sets and reticles, and equipment expenses increased $220,000 in the three months ended March 31, 2005 over the same period in 2004, primarily resulting from increased chip development efforts in the three months ended March 31, 2005 as compared to the same period in 2004.

Sales and Marketing

	Three Months Ended March 31,		% Change in
	2005	2004	2005
Sales and marketing	$ 4,008	$ 3,501	14%
% of net revenue	10%	8%	

The increase in sales and marketing expenses was primarily due to an increase in compensation costs of $317,000 related to a 25% increase in the number of sales and marketing personnel in the first quarter of 2005 as compared to the same period in 2004. Additionally, trade show costs, commissions to independent sales representatives and recruiting fees increased $273,000 during the three months ended March 31, 2005 as compared to the same period in 2004.

General and Administrative

	Three Months Ended March 31,		% Change in
	2005	2004	2005

General and administrative	$ 2,149	$ 2,230	(4)%
% of net revenue	5%	5%	

The decrease in general and administrative expenses was primarily due to decreases in professional fees of $272,000 in the three months ended March 31, 2005 as compared to the same period in 2004. Professional fees were $677,000 during the first quarter of 2004 as compared to $404,000 in the same period in 2005, due to legal services performed related to patent filings and tax accounting fees.

Stock-Based Compensation

	Three Months Ended March 31,		% Change in
	2005	2004	2005
Stock-based compensation	$ 454	$ 1,116	(59)%
% of net revenue	1%	2%	

We have recorded deferred stock-based compensation in connection with the grant of stock options to our employees and directors prior to our initial public offering. At March 31, 2005, we had $1.6 million of deferred stock-based compensation remaining to be amortized.

Interest Income, Net

	Three Months Ended March 31,		% Change in
	2005	2004	2005
Interest income, net	$ 972	$ 153	535%
% of net revenue	2%	1%	

During the three months ended March 31, 2005 we experienced increased interest income as compared to the same period in 2004, resulting from increased cash, cash equivalents and marketable securities, resulting from our initial public offering in February 2004 and working capital generated from operations.

Provision for Income Taxes

	Three Months Ended March 31,		% Change in
	2005	2004	2005
Provision for income taxes	$ 294	$ 233	26%
% of net revenue	(1)%	(1)%	

Our effective tax rate was 15.0% and 8.9% for the three months ended March 31, 2005 and 2004, respectively, which reflects the utilization of net operating loss carryforwards. The provision for income taxes during the three months ended March 31, 2005 and 2004 consisted primarily of U.S. alternative minimum tax and non-U.S. income taxes. The increase in the effective tax rate for the three months ended March 31, 2005 was primarily due to higher net tax from foreign operations as compared to the same period in 2004.

Liquidity and Capital Resources

Our principal sources of liquidity as of March 31, 2005, consisted of cash, cash equivalents and marketable securities of $158.9 million, and our revolving credit facility, under which $10 million was available to borrow.

Operating Activities: Our operating activities provided $4.2 million of cash for the three months ended March 31, 2005 as compared to $2.0 million for the three months ended March 31, 2004. Cash flow from operating activities for the three months ended March 31, 2005 resulted from net income of $1.7 million, an increase in our accounts payable balance of $4.6 million due to the timing of payments for inventory, and a decrease in accounts receivable of $1.7 million due to the timing of collections from our customers, partially offset by an increase in our inventory by $2.7 million, due to inventory growth to meet increased demand. Cash flow from operating activities for the three months ended March 31, 2004 resulted from net income of $2.4 million, an increase in accrued liabilities of $2.5 million due to an increase in accrued marketing development funds associated with increased revenues, an increase in accounts payable of $1.7 million related to increases in inventory, partially offset by an increase in inventory of $3.8 million due to an inventory rise to meet increased demand and an increase in accounts receivable of $2.6 million due to increased revenue and timing of customer payments.

Investing Activities. Our investing activities provided $5.9 million in the three months ended March 31, 2005, and used cash of $23.7 million in the three months ended March 31, 2004. Our investing activities primarily consisted of the purchase and maturities of marketable securities and purchases of property and equipment.

Capital expenditures were $367,000 and $656,000 for the three months ended March 31, 2005 and 2004, respectively. These expenditures primarily consisted of computer and test equipment purchases. We anticipate that further capital expenditures will be required to support future growth and the improvements required for our new corporate headquarters facility in the second quarter of 2005.

Financing Activities. Our financing activities provided cash of $921,000 and $127.4 million in the three months ended March 31, 2005 and 2004, respectively. The cash provided in 2005 primarily related to the issuance of common stock under our employee stock option and employee stock purchase plans. The cash provided in 2004 related to the net proceeds from our initial public offering of $133.2 million, partially offset by the repayment of $5.8 million in outstanding balances on our revolving credit facilities.

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We expect to experience an increase in our operating expenses in absolute dollars, particularly in research and development, but also in sales and marketing and general and administrative expenses, for the foreseeable future in order to execute our business strategy. As a result, we anticipate that operating expenses, as well as planned capital expenditures, will constitute a material use of our cash resources.

We believe that our existing cash and cash equivalents and existing amounts available under our revolving credit facility will be sufficient to meet our anticipated cash needs for at least the next 12 months. Our future capital requirements will depend on many factors including our rate of revenue growth, the timing and extent of spending to support development efforts, the expansion of sales and marketing activities, the timing of introductions of new products and enhancements to existing products, the costs to ensure access to adequate manufacturing capacity and the continuing market acceptance of our products. Although we are currently not a party to any agreement or letter of intent with respect to potential investments in, or acquisitions of, complementary businesses, products or technologies, we may enter into these types of arrangements in the future, which could also require us to seek additional equity or debt financing. The sale of additional equity securities or convertible debt securities would result in additional dilution to our stockholders. Additional debt would result in increased interest expense and could result in covenants that would restrict our operations. We have not made arrangements to obtain additional financing and there is no assurance that such financing, if required, will be available in amounts or on terms acceptable to us, if at all.

Contractual Obligations and Off-Balance Sheet Arrangements

Information regarding our long-term debt payments, operating lease payments and capital lease payments is provided in Management s Discussion and Analysis of Results of Operations and Financial Condition of our Form 10-K filed with the SEC on March 11, 2005.

In April 2005, we entered into an operating lease agreement related to a new corporate headquarters facility located in Santa Clara, California. The initial term of the lease is 61 months commencing June 2005. Future minimum lease payments under the operating lease are $5.8 million.

As of March 31, 2005, we have no off-balance sheet arrangements as defined in Item 303(a)(4) of the SEC s Regulation S-K.

Recent Accounting Pronouncement

In March 2004, the Financial Accounting Standards Board, or FASB, reached a consensus on EITF Issue No. 03-01, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments,* which provides new guidance for assessing impairment losses on investments. Additionally, EITF 03-01 includes new disclosure requirements for investments that are deemed to be temporarily impaired. In September 2004, the FASB delayed the effective date of the recognition and measurement provisions of EITF 03-01. We will evaluate the impact of EITF 03-01 once final guidance is issued.

In December 2004, the FASB issued SFAS No. 153, *Exchanges of Nonmonetary Assets An Amendment of APB Opinion No. 29.* APB Opinion No. 29, *Accounting For Nonmonetary Transactions*, is based on the opinion that exchanges of nonmonetary assets should be measured based on the fair value of the assets exchanged. SFAS No. 153 amends Opinion No. 29 to eliminate the exception for nonmonetary exchanges of similar productive assets and replaces it with a general exception for exchanges of nonmonetary assets whose results are not expected to significantly change the future cash flows of the entity. The provisions of this Statement are effective for nonmonetary asset exchanges occurring in fiscal periods beginning after June 15, 2005. The adoption of SFAS No. 153 is not expected to have any impact on our consolidated financial condition or results of operations.

We account for stock-based compensation awards issued to employees using the intrinsic value measurement provisions of APB Opinion No. 25, *Accounting for Stock Issued to Employees*. Accordingly, no compensation expense has been recorded for stock options granted with exercise prices greater than or equal to the fair value of the underlying common stock at the option grant date. On December 16, 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment,* or SFAS 123R. SFAS 123R eliminates the alternative of applying the intrinsic value measurement provisions of Opinion 25 to stock compensation awards issued to employees. Rather, the new standard requires enterprises to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award. That cost will be recognized over the period during which an employee is required to provide services in exchange for the award, known as the requisite service period.

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We have not yet quantified the effects of the adoption of SFAS 123R, but it is expected that the new standard will result in significant stock-based compensation expense. The pro forma effects on net results of operations and earnings per share if we had applied the fair value recognition provisions of the original SFAS 123 on stock compensation awards (rather than applying the intrinsic value measurement provisions of Opinion 25) are disclosed above. Although such pro forma effects of applying original SFAS 123 may be indicative of the effects of adopting SFAS 123R, these pro forma effects should not be relied upon in determining the effects on net results of operations of adopting SFAS 123R as the provisions of these two statements differ in some important respects. The actual effects of adopting SFAS 123R will be dependent on numerous factors including, but not limited to, the valuation model chosen by us to value stock-based awards; the assumed award forfeiture rate; the accounting policies adopted concerning the method of recognizing the fair value of awards over the requisite service period; and the transition method chosen for adopting SFAS 123R.

In April 2005, the effective date of SFAS 123R was deferred to our fiscal quarter beginning January 1, 2006. SFAS 123R requires the use of the Modified Prospective Application Method. Under this method SFAS 123R is applied to new awards and to awards modified, repurchased, or cancelled after the effective date. Additionally, compensation cost for the portion of awards for which the requisite service has not been rendered, such as unvested options, that are outstanding as of the date of adoption shall be recognized as the remaining requisite services are rendered. The compensation cost relating to unvested awards at the date of adoption shall be based on the grant-date fair value of those awards as calculated for pro forma disclosures under the original SFAS 123. In addition, companies may use the Modified Retrospective Application Method. This method may be applied to all prior years for which the original SFAS 123 was effective or only to prior interim periods in the year of initial adoption. If the Modified Retrospective Application Method is applied, financial statements for prior periods shall be adjusted to give effect to the fair-value-based method of accounting for awards on a consistent basis with the pro forma disclosures required for those periods under the original SFAS 123.

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FACTORS THAT MAY AFFECT OUR RESULTS

Risks Related to Our Business

Fluctuations in our operating results on a quarterly and annual basis could cause the market price of our common stock to decline.

Our revenue and operating results have fluctuated significantly from period to period in the past and are likely to do so in the future. These fluctuations could cause the market price of our common stock to decline. As a result, you should not rely on period to period comparisons of our operating results as an indication of our future performance. In future periods, our revenue and results of operations may be below the expectations of analysts and investors, which could cause the market price of our common stock to decline. Factors that are likely to cause our revenue and operating results to fluctuate include those discussed in the risk factors below.

We do not expect to sustain our recent growth rate, and we may not be able to manage our future growth effectively.

We have experienced significant growth in a short period of time. Our revenue has increased from $22.2 million in 2002, to $87.4 million in 2003 and $169.6 million in 2004. We do not expect similar revenue growth rates in future periods. For example, our revenue in the first quarter of 2005 of $41.2 million was lower than revenue in the fourth quarter of 2004 of $41.7 million and revenue in the first quarter of 2004 of $43.1 million. Growth and expansion of our operations may place a significant strain on our resources and increased demands on our management information and reporting systems, financial and management controls and personnel. We may not be able to develop the internal capabilities or collaborative relationships required to manage future growth and expansion or to support future operations. If we are unable to manage growth effectively, our financial results could be adversely affected.

Although we have recently achieved profitability, we may incur losses in the future. Accordingly, we may not be able to generate sufficient revenue in the future to sustain profitability.

At March 31, 2005, we had an accumulated deficit of approximately $72.1 million. During 2003, we incurred $49.8 million in operating expenses and a net loss of $13.2 million. During 2004, we incurred operating expenses of $68.6 million and generated net income of $10.8 million. To sustain profitability, we will need to maintain or increase our revenue while maintaining reasonable cost and expense levels. In addition, since we expect average selling prices of our products to continue to decrease in the future, we will need to continue to reduce the average unit costs of our products and increase sales volumes to maintain profitability. We expect to increase expense levels in absolute dollars in each of the next several quarters to support increased research and development efforts related to new and existing product development and sales and marketing efforts. Because many of our expenses are fixed in the short term, or are incurred in advance of anticipated sales, we may not be able to decrease our expenses in a timely manner to offset any shortfall of sales. We may not be able to sustain or increase profitability on a quarterly or an annual basis.

If demand for our chipsets declines or does not grow, we will be unable to increase or sustain our revenue and our business will be severely harmed.

We derive substantially all of our revenue from the sale of chipsets for wireless applications. We currently expect our chipsets for wireless applications to account for substantially all of our revenue for the foreseeable future. If we are unable to develop new products in a timely manner or demand for our chipsets declines as a result of competition or technological changes, it would have a material negative impact on our business, operating results and financial position and our competitive position. The markets for our products are characterized by frequent introduction of next generation and new products, short product life cycles and significant price competition. If we or our customers are unable to manage product transitions in a timely and cost-effective manner, our business and results of operations will suffer. In addition, frequent technology changes and introduction of next generation products may result in inventory obsolescence, which could reduce our gross margins and adversely affect our operating performance.

Since we have limited visibility as to the volume of sales of our products by our customers and inventory levels of our products held by our customers, our ability to forecast accurately future demand for and sales of our products is limited.

We sell our chipsets to OEMs who integrate our chipsets into their products or to ODMs who include our chipsets in the products they supply to OEMs. We have limited visibility as to the volume of our products that our OEM and ODM customers are selling to their customers or carrying in their inventory. If our customers have excess inventory or experience a slowing of products sold through to their end customers, it would likely result in a slowdown in orders from our customers and adversely impact our future sales.

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The average selling prices of products in our markets have historically decreased rapidly and will likely do so in the future, which could harm our revenue and gross profits.

The products we develop and sell are used for high volume applications and are subject to rapid declines in average selling prices. While our average selling prices were sequentially flat in the most recent quarter, they have historically decreased significantly in order to meet market demand, and we expect that we will continue to reduce prices in the future. Reductions in our average selling prices to one customer could impact our average selling prices to all customers. Historically, we have been able to substantially offset reductions in our average selling prices with decreases in our product and operating costs and increases in our unit volumes. Our financial results will suffer if we are unable to offset any future reductions in our average selling prices by increasing our unit volumes, reducing our costs or developing new or enhanced products on a timely basis with higher selling prices or gross margins. While gross margins may decline as a result of reductions in average selling prices, we may continue to incur research and development costs at higher or existing levels to develop future products. This continued spending would have an adverse impact on our immediate operating results if our revenue does not continue to grow or our gross margins decline.

We may not be able to compete effectively and increase or maintain revenue and market share.

We may not be able to compete successfully against current or potential competitors. If we do not compete successfully, our market share and revenue may decline. We compete with large semiconductor manufacturers and designers and start-up integrated circuit companies. Most of our current and potential competitors have longer operating histories, significantly greater resources and name recognition and a larger base of customers than we do. This may allow them to respond more quickly than us to new or emerging technologies or changes in customer requirements. In addition, these competitors may have greater credibility with our existing and potential customers. Moreover, our competitors have been doing business with customers for a longer period of time and have established relationships, which may provide them with information regarding future trends and requirements that may not be available to us. In addition, some of our larger competitors may be able to provide greater incentives to customers through rebates and marketing development funds and similar programs. Some of our competitors with multiple product lines may bundle their products to offer a broader product portfolio or integrate wireless functionality into other products that we do not sell, which may make it difficult for us to gain or maintain market share. For example, Intel markets its Centrino mobile technology brand and we believe they provide a substantial marketing development fund incentive for buyers of a combination of its microprocessor, related chipsets and wireless networking module that use the brand. Intel or other large competitors may also be able to discourage OEMs from placing our brand on their products, which could substantially harm our marketing efforts.

We depend on key personnel and consultants to operate our business, and if we are unable to retain our current personnel and hire additional personnel, our ability to develop and successfully market our products could be harmed.

We believe our future success will depend in large part upon our ability to attract and retain highly skilled managerial, engineering and sales and marketing personnel. The loss of any key employees or the inability to attract or retain qualified personnel, including engineers and sales and marketing personnel, could delay the development and introduction of, and harm our ability to sell, our products and harm the market s perception of us. We believe that our future success is highly dependent on the contributions of our senior management, including our President and Chief Executive Officer and our senior engineering personnel. We do not have long-term employment contracts with these or any other key personnel, and their knowledge of our business and industry would be extremely difficult to replace.

There is currently a shortage of qualified technical personnel with significant experience in the design, development, manufacture, marketing and sales of integrated circuits for use in wireless products. Our key technical personnel and consultants represent a significant asset and serve as the source of our technological and product innovations. We may not be successful in attracting and retaining sufficient numbers of technical personnel to support our business plan.

If we fail to develop and introduce new products and enhancements for wireless applications or if our proprietary features do not achieve market acceptance on a timely basis, our ability to attract and retain customers could be impaired, and our competitive position may be harmed.

The wireless communications market is characterized by rapidly changing technology, evolving industry standards, rapid changes in customer requirements and frequent product introductions. We must continually design, develop and introduce new products with improved features to be competitive. Our current and future products may not achieve market acceptance or adequately address the changing needs of the wireless market, and we may not be successful in developing and marketing new products or enhancements to our existing products on a timely basis. The introduction of products embodying new technologies, the emergence of new industry standards or changes in customer requirements could render our existing products obsolete and unmarketable. In addition, we introduce from time to time products with proprietary enhancements. Although we believe our products are fully compliant with applicable industry standards, proprietary enhancements may not in the future result in full conformance with existing industry standards under all circumstances. Our introduction of proprietary features involves risks associated with market acceptance

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of these new products and certification by industry standards groups. We have reviewed the rules and regulations of the various standards bodies and related industry organizations to which we belong or with which we are affiliated, and we believe there is not a significant risk that action would be taken that would undermine our ability to continue to exploit our affiliation with these organizations.

The development of our products is highly complex. We occasionally have experienced delays in completing the development and introduction of new products and product enhancements, and we could experience delays in the future. Unanticipated problems in developing wireless products could also divert substantial engineering resources, which may impair our ability to develop new products and enhancements and could substantially increase our costs. Even if the new and enhanced products are introduced to the market, we may not be able to achieve market acceptance of these products and our proprietary features in a timely manner.

We have and will continue to expend substantial resources developing products for new applications or markets and may never achieve the sales volume for these products that we anticipate, which may limit our future growth and harm our results of operations.

With the exception of our recently announced product for the PHS cellular handset market, all of our products introduced to date have been for use in wireless networking applications. Our strategy includes developing and introducing new products for use in applications other than wireless networking. Our future success will depend in part upon the success of any such products, and we face a number of risks in connection with these products, including those described in other risk factors in this report. We have in the past, and will likely in the future, expend substantial resources in developing new and additional products for new applications and markets. We may experience unforeseen difficulties and delays in developing these products and defects upon volume production and broad deployment. In addition, we have no experience in markets other than wireless networking, and may be unsuccessful in marketing and selling any products we develop. The markets we choose to enter will likely be highly competitive and many of our competitors will have substantially more experience in these markets. Our success will depend on the growth of the markets we enter and the competitiveness of our products. If we choose to enter markets that do not achieve or sustain the growth we anticipate, or if our products are not competitive, we may not achieve volume sales, which may limit our future growth and harm our results of operations.

If our new product for the PHS cellular market is not successful, our future results will be harmed.

We recently introduced a new product for the PHS cellular handset market. Our future success will depend in part upon the success of this product, and we face a number of risks in connection with the product, including those described in the risk factors in this report. Since the product is newly developed, we may experience unforeseen defects in this product upon volume production and broad deployment. In addition, we have no experience in the cellular market, and may be unsuccessful in marketing and selling this product. Since the China PHS cellular market is dominated by a very small number of handset providers, we will rely on these providers for sales of our new product. If these providers are not successful in this market, or if they do not choose to incorporate our products into a significant number of their handsets, we will not be successful in selling our product. The market for cellular handset semiconductors is highly competitive and many of our competitors have substantially more experience in this market. There are a number of cellular technologies, some of which have technological advantages over PHS, and the market for PHS cellular may not continue to grow or remain a successful technology. If this product is not successful, our future growth would likely be limited and our future results harmed.

We depend on a small number of customers for a significant portion of our revenue. If we fail to retain or expand customer relationships, our revenue could decline.

We derive a significant portion of our revenue from a small number of customers, and we anticipate that we will continue to do so in the foreseeable future. These customers may decide not to purchase our products at all, to purchase fewer products than they did in the past, for example due to an increase in inventory, or to alter their purchasing patterns in some other way, particularly because substantially all of our sales are made on a purchase order basis, which permits our customers to cancel, change or delay product purchase commitments with little or no notice to us and without penalty.

In the three months ended March 31, 2005, Cameo Communications, Inc., Hon-Hai Precision Industry, Alpha Networks, Inc. and Askey Computer Corporation accounted for 21%, 17%, 13% and 10% of our net revenue, respectively. In the year ended December 31, 2004, Hon-Hai Precision Industry, Askey Computer Corporation, Global Sun Technology Inc. and Alpha Networks, Inc. accounted for 23%, 17%, 11% and 10% of our net revenue, respectively. Some of our original equipment manufacturer customers are also original design manufacturer customers, which may increase the impact of the loss of any customer. We must obtain orders from new customers on an ongoing basis to increase our revenue and grow our business. Our largest customers are typically original design manufacturers. Sales to our largest customers have fluctuated significantly from period to period primarily due to original equipment manufacturers that incorporate our products changing their designated original design manufacturer and the continued diversification of our original equipment manufacturer customer base in our current markets. We believe that sales will likely continue to fluctuate significantly in the future as we enter into new markets. The loss of any significant customer, a significant reduction in sales we make to them, or any problems collecting receivables from them would likely harm our financial condition and results of operations.

We will have difficulty selling our products if customers do not design our products into their product offerings or if our customers product offerings are not commercially successful.

We sell our products directly to original equipment manufacturers, who include our chipsets in their products, and to original design manufacturers, who include our chipsets in the products they supply to original equipment manufacturers. Our products are generally incorporated into our customers products at the design stage. As a result, we rely on original equipment manufacturers to design our products into the products they sell. Without these design wins, our business would be materially and adversely affected. We often incur significant expenditures on the development of a new product without any assurance that an original equipment manufacturer will select our product for design into its own product. Once an original equipment manufacturer designs a competitor s product into its product offering, it becomes significantly more difficult for us to sell our products to that customer because changing suppliers involves significant cost, time, effort and risk for the customer. Furthermore, even if an original equipment manufacturer designs one of our products into its product offering, we cannot be assured that its product will be commercially successful, that we will receive any revenue from that manufacturer or that a successor design will include one of our products.

The complexity of our products could result in unforeseen delays or expenses from undetected defects, errors or bugs in hardware or software, which could reduce the market acceptance for our new products, damage our reputation with current or prospective customers and adversely affect our operating costs.

Highly complex products such as our chipsets and the related reference designs we provide to our customers frequently contain defects, errors and bugs when they are first introduced or as new versions are released. We have in the past and may in the future experience these defects, errors and bugs. If any of our products have reliability, quality, or compatibility problems, we may not be able to successfully correct these problems. In addition, if any of our proprietary features contain defects, errors or bugs when first introduced or as new versions are released, we may be unable to correct these problems. Consequently, our reputation may be damaged and customers may be reluctant to buy our products, which could harm our ability to retain existing customers and attract new customers and our financial results. In addition, these defects, errors or bugs could interrupt or delay sales to our customers. If any of these problems are not found until after we have commenced commercial production of a new product, we may be required to incur additional development costs and product recalls, repairs or replacement costs. These problems may also result in claims against us by our customers or others.

Because we do not have long-term commitments from our customers, we must estimate customer demand, and errors in our estimates can have negative effects on our inventory levels, sales and operating results.

Our sales are largely made on the basis of individual purchase orders rather than long-term purchase commitments. Our customers have the right to cancel or defer some purchase orders. We have experienced in the past cancellations or deferrals of purchase orders, and additional cancellations and deferrals may occur from time to time. We have historically placed firm orders for products with our foundries up to approximately 16 weeks prior to the anticipated delivery date and typically prior to receiving an order for the product. Therefore, our order volumes are based on our forecasts of demand from our customers. This process requires us to make multiple demand forecast assumptions, each of which may introduce error into our estimates. If we overestimate customer demand or incorrectly estimate product mix, we may allocate resources to manufacturing products that we may not be able to sell when we expect or at all. As a result, we would have excess inventory, which would harm our financial results. Conversely, if we underestimate customer demand or if insufficient manufacturing capacity is available, we would forego revenue opportunities, lose market share and damage our customer relationships. On occasion, we have been unable to adequately respond to increases in customer purchase orders, and therefore, were unable to complete, or needed to delay, sales. We have in the past, and may in the future, allocate our supply among our customers. Product allocation may result in the loss of current customers, and if we are unable to commit to provide specified quantities of products over a given period of time, we will not attract new customers. The failure to maintain customer relationships would decrease our revenue and harm our business.

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 continually work to improve our chipsets and, in particular, our high-performance radio frequency products, to be manufactured using increasingly smaller geometries and to achieve higher levels of design integration. These ongoing efforts require us from time to time to modify the manufacturing processes for our products and to redesign some products. To remain competitive, our chipset must be redesigned from time to time, which may result in delays in product deliveries. We periodically evaluate the benefits, on a product-by-product basis, of migrating to smaller geometry process technologies to reduce our costs. 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. In addition, while we purchase wafers from foundries, we also assume the yield risk related to manufacturing these wafers into die. We may face similar difficulties, delays and expenses in the future. We depend on our relationships with our foundries to transition to smaller geometry processes successfully and cannot assure that our foundries will be able to effectively manage the transition. If our foundries, or we, experience significant delays in this transition or fail to efficiently implement these transitions, our business, financial condition and results of operations could be adversely affected.

We rely on a limited number of independent foundries and subcontractors for the manufacture, assembly and testing of our chipsets, and the failure of any of these third-party vendors to deliver products or otherwise perform as requested could damage our relationships with our customers, decrease our sales and limit our growth.

We do not have our own manufacturing or assembly facilities and have limited in-house testing facilities. Therefore, we must rely on third-party vendors to manufacture, assemble and test the products we design. We rely on Taiwan Semiconductor Manufacturing Corporation in Taiwan and Semiconductor Manufacturing International Corporation in Shanghai, China to produce all of our chips. We also rely on Amkor Technology, Inc. in China and Korea, ASAT Holdings Limited in China and Hong Kong, Siliconware Precision Industries Co., Ltd. in Taiwan, ST Assembly Test Services Ltd. in Singapore and other third-party assembly and test subcontractors to assemble, package and test our products. If these vendors do not provide us with high-quality products, services and production and test capacity in a timely manner, or if one or more of these vendors terminates its relationship with us, we may be unable to obtain satisfactory replacements to fulfill customer orders on a timely basis, our relationships with our customers could suffer, our sales could decrease and our growth could be limited.

We face risks associated with relying on third-party vendors for the manufacture, assembly and testing of our chipsets.

We face significant risks associated with relying on third-party vendors, including:

- reduced control over product cost, delivery schedules and product quality;
- potential price increases;
- inability to achieve sufficient production, increase production or test capacity and achieve acceptable yields on a timely basis;
- increased exposure to potential misappropriation of our intellectual property;
- shortages of materials that foundries use to manufacture products;
- capacity shortages; and
- labor shortages or labor strikes.

We do not have long-term supply contracts with our third-party manufacturing vendors and they may allocate capacity to other customers and may not allocate sufficient capacity to us to meet future demands for our products.

We currently do not have long-term supply contracts with any of our third-party vendors. Therefore, they are not obligated to perform services or supply products to us for any specific period, in any specific quantities, or at any specific price, except as may be provided in a particular accepted purchase order. None of our third-party foundry or assembly and test vendors has provided contractual assurances to us that adequate capacity will be available to us to meet future demand for our products. These foundries and assembly and test vendors may allocate capacity to the production of other companies products while reducing deliveries to us on short notice. In particular, other customers that are larger and better financed than us or that have long-term agreements with these foundries or assembly and test vendors may cause these foundries or assembly and test vendors to reallocate capacity to those customers, decreasing the capacity available to us. If we enter into costly arrangements with suppliers that include nonrefundable deposits or loans in exchange for capacity commitments, commitments to purchase specified quantities over extended periods or investment in a foundry, our operating results could be harmed. To date, we have not entered into such arrangements with our suppliers. If we need another integrated circuit foundry or assembly and test subcontractor because of increased demand, or the inability to obtain timely and adequate deliveries from our providers, we might not be able to cost-effectively and quickly retain other vendors to satisfy our requirements.

If our third-party foundries or suppliers do not achieve satisfactory yields or quality, our relationships with our customers and our reputation will be harmed.

The fabrication of chipsets is a complex and technically demanding process. Minor deviations in the manufacturing process can cause substantial decreases in yields, and in some cases, cause production to be suspended. Our third-party foundries and suppliers have from time to time experienced manufacturing defects and reduced manufacturing yields. Changes in manufacturing processes or the inadvertent use of defective or contaminated materials by our foundries could result in lower than anticipated manufacturing yields or unacceptable performance. Many of these problems are difficult to detect at an early stage of the manufacturing process and may be time consuming and expensive to correct. In addition, designing radio frequency circuits using standard, complementary metal-oxide semiconductor processes is difficult and can result in unsatisfactory yields. Because we purchase wafers, our exposure to low wafer yields from our foundries is increased. Poor yields from our foundries or defects, integration issues or other performance problems in our products could cause us significant customer relations and business reputation problems, or force us to sell our products at lower gross margins and therefore harm our financial results. In addition, manufacturing defects may not be detected by our testing, or may be caused by defective packaging of our products by our third-party suppliers. If these defects arise or are discovered after we have shipped our products, our reputation and business would suffer.

If we fail to secure or protect our intellectual property rights, competitors may be able to use our technologies, which could weaken our competitive position, reduce our revenue or increase our costs.

We rely on a combination of patent, copyright, trademark and trade secret laws, confidentiality procedures and licensing arrangements to establish and protect our proprietary rights. Our pending patent applications may not result in issued patents, and our existing and future patents may not be sufficiently broad to protect our proprietary technologies or may be held invalid or unenforceable in court. Policing unauthorized use of our products is difficult and we cannot be certain that the steps we have taken will prevent the misappropriation or unauthorized use of our technologies, particularly in foreign countries where the laws may not protect our proprietary rights as fully as United States law. Any patents we have obtained, or may obtain in the future, may not be adequate to protect our proprietary rights. Our competitors may independently develop or may have already developed similar technology, duplicate our products or design around any patents issued to us or other intellectual property rights. In addition, we may be required to license our patents as a result of our participation in various standards organizations.

Because we license some of our software source code directly to customers, we face increased risks that our trade secrets will be exposed through inadvertent or intentional disclosure, which could harm our competitive position or increase our costs.

We license some of our software source code to our customers, which increases the number of people who have access to some of our trade secrets and other proprietary rights. Contractual obligations of our licensees not to disclose or misuse our source code may not be sufficient to protect us from disclosure or misuse. The costs of enforcing contractual rights could substantially increase our operating costs and may not ultimately succeed in protecting our proprietary rights. If our competitors access our source code, they may gain further insight into the technology and design of our products, which would harm our competitive position.

Intellectual property litigation, which is common in our industry, could be costly, harm our reputation, limit our ability to license or sell our proprietary technologies or products and divert the attention of management and technical personnel.

The wireless communications market is characterized by frequent litigation regarding patent and other intellectual property rights. In the last few years, we received several written notices or offers from our competitors and others claiming to have patent rights in certain technology and inviting us to license this technology and related patents that apply to the Institute of Electrical and Electronics Engineers, or IEEE, family of wireless local area networking standards, including the 802.11b, 802.11g and 802.11a wireless standards as well as other technology and patents relevant to other standards related to our chips, software and system solutions. These notices or offers have been made directly to us and through our U.S. and foreign customers. We have certain indemnification obligations to customers with respect to any infringement of third-party patents and intellectual property rights by our products. We have responded directly, or indirectly through our customers, to all of these notices, and continue to correspond regarding the offers with some of the parties that have sent the notices. None of these notices or offers to license has included an explicit threat of, or resulted in, litigation against us. While at least one of our customers has been sued by the holder of a patent related to 802.11b, 802.11g and 802.11a technology, none of these notices or offers to license has to date included an explicit threat of, or resulted in, litigation against us.

Questions of infringement in the wireless communications market involve highly technical and subjective analyses. Litigation may be necessary in the future to enforce any patents we may receive and other intellectual property rights, to protect our trade secrets, to determine the validity and scope of the proprietary rights of others, or to defend against claims of infringement or invalidity, and we may not prevail in any future litigation. If litigation were to be filed against us in connection with an offer to license technology or claims of infringement, our business could be harmed. Litigation, whether or not determined in our favor or settled, could be costly, could harm our reputation and could divert the efforts and attention of our management and technical personnel from normal business

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operations. In addition, adverse determinations in litigation could result in the loss of our proprietary rights, subject us to significant liabilities, require us to seek licenses from third parties or prevent us from licensing our technology or selling our products, any of which could seriously harm our business. Any of these consequences could result from litigation whether initiated by our competitors or others, including those that have already sent notices or offers to us and our customers claiming patent rights and offering licenses.

Any potential dispute involving our patents or other intellectual property could also include our industry partners and customers, which could trigger our indemnification obligations to them and result in substantial expense to us.

In any potential dispute involving our patents or other intellectual property, our customers or licensees could also become the target of litigation, and certain customers have received notices of written offers from our competitors and others claiming to have patent rights in certain technology and inviting our customers to license this technology. At least one customer has been sued outside the U.S. for allegedly infringing a patent related to 802.11b, 802.11g and 802.11a technology. Because we indemnify our customers for intellectual property claims made against them for products incorporating our technology, any litigation could trigger technical support and indemnification obligations in some of our license or sales agreements, which could result in substantial expenses. In addition to the time and expense required for us to supply support or indemnification to our customers, any such litigation could severely disrupt or shut down the business of our customers, which in turn could hurt our relations with our customers and cause the sale of our proprietary technologies and products to decrease.

We face business, political, regulatory, operational, financial and economic risks because most of our operations and sales activities take place outside of the United States.

A significant portion of our products is sold to customers outside the United States and Canada. Sales to customers in Asia accounted for substantially all of our net revenue since 2003. Because many of our original design manufacturer customers are located in Asia, we anticipate that substantially all of our revenue will continue to be represented by sales to customers in that region. In addition, we conduct research and development activities in India and have sales, marketing and support personnel in Japan, Taiwan, Korea, Hong Kong, Macao and China. Our success depends upon continued expansion of our international operations. Our international business involves a number of risks, including:

- multiple, conflicting and changing laws and regulations, tax laws, export and import restrictions, employment laws, regulatory requirements and other governmental approvals, permits and licenses;
- difficulties in staffing and managing foreign operations as well as cultural differences;
- trade restrictions or higher tariffs that favor local competition in some countries;
- difficulties of managing sales representatives, especially because we expect to increase our sales through our sales representatives;
- inadequate local infrastructure and transportation delays;
- financial risks, such as longer payment cycles, greater difficulty collecting accounts receivable and exposure to foreign currency exchange rate fluctuations;

failure by us or our customers to gain regulatory approval for use of our products; and

political and economic instability, including wars, terrorism, and political unrest, recurrence of the SARS or any other outbreak, boycotts, curtailment of trade and other business restrictions.

Any of these factors could significantly harm our future international sales and operations, consequently, our revenue and results of operations and business and financial condition.

Our headquarters are located in California, and we have sales offices in Japan and elsewhere in Asia, and a research and development facility in India. Our third-party foundries and subcontractors are concentrated in Asia and elsewhere in the Pacific Rim. These areas are subject to significant earthquake and earthquake-related risks. Any disruption to the operations of these offices, foundries and subcontractors resulting from earthquakes or other natural disasters could cause significant delays in the production, shipment and sales of our products.

Taiwan Semiconductor Manufacturing Corporation and Semiconductor Manufacturing International Corporation, which manufacture our chipsets and perform substantially all of our assembly and testing facilities, are located in Asia. In addition, our headquarters are located in Northern California, and we have sales offices in Japan, Taiwan, Hong Kong and elsewhere in Asia, and a research and development facility in India. The risk of an earthquake or an earthquake-related disaster such as a tsunami in the Pacific Rim region or the Indian Ocean region, including Asia and Northern California, is significant due to the proximity of major earthquake fault lines. In September 1999, a major earthquake in Taiwan affected the facilities of several of these third-party contractors, as well as other providers of these services. As a result of this earthquake, these contractors suffered power outages and disruptions that impaired their production capacity. In addition, the tsunami in December 2004 caused widespread destruction and disruption of business in India and throughout the Indian Ocean coastal region. The occurrence of additional earthquakes or other natural disasters could result in the disruption of our foundry or assembly and test capacity, or our ability to market and sell our products. We may not be able to obtain alternate capacity on favorable terms, if at all.

We rely upon third parties for technology that is integrated into some of our products, and if we are unable to continue to use this technology and future technology or the technology fails to operate, our ability to sell technologically advanced products would be limited.

We rely on third parties for technology that is integrated into some of our products. If we are unable to continue to use or license on reasonable terms third-party technologies used in some of our products or the technology fails to operate, we may not be able to secure alternatives in a timely manner and our business would be harmed.

While we believe that we currently have adequate internal controls over financial reporting, we are exposed to risks from recent legislation requiring companies to evaluate those internal controls.

Section 404 of the Sarbanes-Oxley Act of 2002 requires our management to report on, and our independent auditors to attest to, the effectiveness of our internal control structure and procedures for financial reporting. We have an ongoing program to perform the system and process evaluation and testing necessary to comply with these requirements. This legislation is relatively new and neither companies nor accounting firms have significant experience in complying with its requirements. As a result, we expect to incur increased expense and to devote additional management resources to Section 404 compliance. In the event that our chief executive officer, chief financial officer or independent registered public accounting firm determine that our internal controls over financial reporting are not effective as defined under Section 404, investor perceptions of our company may be adversely affected and could cause a decline in the market price of our stock.

Changes to financial accounting standards may affect our results of operations and cause us to change our business practices.

We prepare our financial statements to conform with generally accepted accounting principles, or GAAP, in the United States. These accounting principles are subject to interpretation by the American Institute of Certified Public Accountants, the Securities and Exchange Commission and various bodies formed to interpret and create appropriate accounting policies. A change in those policies can have a significant effect on our reported results and may affect our reporting of transactions completed before a change is announced. Changes to those rules or the questioning of current practices may adversely affect our reported financial results or the way we conduct our business. For example, accounting policies affecting many aspects of our business, including rules relating to employee stock option grants, have recently been revised or are under review. The Financial Accounting Standards Board and other agencies have finalized changes to U.S. generally accepted accounting principles that will require us, starting in our first quarter of 2006, to record a charge to earnings for employee stock option grants and other equity incentives. We may have significant and ongoing accounting charges resulting from option grants and other equity incentive expensing that could reduce our overall results of operations. In addition, since we historically have used equity-related compensation as a component of our total employee compensation program, the accounting change could make the use of equity-related compensation less attractive to us and therefore make it more difficult to attract and retain employees.

Risks Related to Our Industry

Any future downturns in the semiconductor industry may reduce our revenue and result in excess inventory.

The semiconductor industry is highly cyclical and is characterized by constant and rapid technological change, rapid product obsolescence and price erosion, evolving standards, short product life cycles and wide fluctuations in product supply and demand. The industry has, from time to time, experienced significant downturns, often connected with, or in anticipation of, maturing product cycles of both semiconductor companies and their customers products and declines in general economic conditions. These downturns have been characterized by diminished product demand, production overcapacity, high inventory levels and accelerated erosion of average selling prices. Any future downturns may reduce our revenue or our percentage of revenue growth on a quarter-to-quarter basis and result in us having excess inventory. Furthermore, any upturn in the wireless communications market in which we sell our chipsets could result in increased competition for access to limited third-party foundry, assembly and test capacity.

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Changes in current laws or regulations or the imposition of new laws or regulations could impede the sale of our products or otherwise harm our business.

Wireless networks can only operate in the frequency bands, or spectrum, allowed by regulators and in accordance with rules governing how the spectrum can be used. The Federal Communications Commission, or the FCC, in the United States, as well as regulators in foreign countries, have broad jurisdiction over the allocation of frequency bands for wireless networks. We therefore rely on the FCC and international regulators to provide sufficient spectrum and usage rules. For example, countries such as China, Japan or Korea heavily regulate all aspects of their wireless communications industries, and may restrict spectrum allocation or usage, or may impose requirements that render our products or our customers products unmarketable in these jurisdictions. If this were to occur, it would make it difficult for us to sell our products in that region. In addition, some of our chipsets operate in the 5 gigahertz, or GHz, band, which is also used by government and commercial services such as military and commercial aviation. The FCC and European regulators have traditionally protected government uses of the 5GHz, bands by setting power limits and indoor and outdoor designation and requiring that wireless local area networking devices not interfere with other users of the band such as government and civilian satellite services. Changes in current laws or regulations, reversal of usage rights, or the imposition of new laws and regulations in the United States or elsewhere regarding the allocation and usage of the 5 GHz band on us, our customers or the industries in which we operate may materially and adversely impact the sale of our products and our business, financial condition and results of operations.

Rapidly changing standards could make our products obsolete, which would cause our operating results to suffer.

We design some of our products to conform to standards set by industry standards bodies such as the Institute of Electrical and Electronics Engineers, Inc. We also depend on industry groups such as the WiFi Alliance to certify and maintain certification of our products. If our customers adopt new or competing industry standards with which our products are not compatible, or such industry groups fail to adopt standards with which our products are compatible, our existing products would become less desirable to our customers and our sales would suffer. The emergence of markets for our chipsets is affected by a variety of factors beyond our control. In particular, our products are designed to conform to current specific industry standards. Competing standards may emerge that are preferred by our customers, which could also reduce our sales and require us to make significant expenditures to develop new products. For example, the IEEE has initiated working group proceedings directed at promulgating a new wireless local area networking standard, called 802.11n, that may be, or may be perceived by customers as being, superior to the standards with which our current products comply. If adoption of 802.11n and pre-802.11n products becomes widespread before we offer such products, we will lose customers and revenue and our business will be harmed.

If our customers or the industries using wireless technology prefer to integrate wireless capability into other products, we may not be able to compete effectively, we will lose customers, our revenue will decline and our business will be harmed.

We have adopted the strategy of maintaining wireless technology on a chipset that is separate from functionality contained on other chips within a product. Our customers or the industries using wireless technology may prefer to integrate wireless capability into other products such as DSL modems, or determine that an integrated chip with multiple functionality results in products that perform better or are less expensive or more efficient to manufacture. If wireless functionality becomes commonly integrated with other functionality, the market for our products may decline. Consequently, we may miss product cycles in order to redesign our products, and we may not be able to forge strategic relationships necessary in order to design and arrange for the production of chips that include multiple functionality. If we miss product cycles, we will lose customers, our revenue will decline and our business will be harmed.

The proliferation of wireless devices may expand beyond the capacity of the channels available in the 2.4GHz or 5 GHz bands, which may overload the networks and result in decreased market demand for our products.

Wireless networks currently operate in the 2.4 GHz or 5 GHz bands, within which there are a limited number of channels available for use. The increasing number of wireless devices and networks may overburden the frequency bands and overload the networks. Recent studies have predicted that congestion in the 2.4 GHz band could result from the increasing number of wireless devices using that band with limited channel availability. If this occurs, our customers or the industries in which we operate may be adversely affected because the networks become inoperable or because only a limited number of devices will be able to access the networks. In turn, we may experience a decrease in market demand for our products that would adversely impact our business and results of operations.

We may experience a decrease in market demand due to uncertain economic conditions in the United States and in international markets, which has been further exacerbated by the concerns of terrorism, war and social and political instability.

Economic growth in the United States and international markets has slowed significantly and the United States economy has recently been in a recession. The timing of a full economic recovery is uncertain. In addition, the terrorist attacks in the United States,

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the continued presence of United States military forces in Iraq, and turmoil in the Middle East have contributed to the uncertainty in the United States economy and may lead to a decline in economic conditions, both domestically and internationally. Further terrorist acts and similar events, or additional wars in general, could contribute further to a slowdown of the market demand for goods and services, including demand for our products. If the economy declines as a result of the recent economic, political and social turmoil, or if there are further terrorist attacks in the United States or elsewhere, we may experience decreases in the demand for our products and services, which may harm our operating results.

Risks related to the market for our common stock

Because the Nasdaq National Market is likely to continue to experience extreme price and volume fluctuations, the price of our stock may decline.

Since we completed our initial public offering in February 2004, the market price of our shares has been and likely will continue to be highly volatile and could be subject to wide fluctuations in response to numerous factors, including the following:

- actual or anticipated variations in our quarterly operating results or those of our competitors;
- announcements by us or our competitors of new products or technological innovations;
- introduction and adoption of new industry standards;
- changes in financial estimates or recommendations by securities analysts;
- changes in the market valuations of our competitors;
- announcements by us or our competitors of significant acquisitions or partnerships; and
- sales of our common stock.

Many of these factors are beyond our control and may negatively impact the market price of our common stock, regardless of our performance. In addition, the stock market in general, and the market for technology and semiconductor companies in particular, have been highly volatile. Our common stock may not trade at the same levels of shares as that of other semiconductor and technology companies, and shares of semiconductor and technology companies, in general, may not sustain their current market prices. In the past, securities class action litigation has often been brought against a company following periods of volatility in the market price of its securities. We may be the target of similar litigation in the future. Securities litigation could result in substantial costs and divert management s attention and resources, which could seriously harm our business and operating results.

Our ability to raise capital in the future may be limited and our failure to raise capital when needed could prevent us from executing our growth strategy.

We believe that our existing cash and cash equivalents and existing amounts available under our revolving credit facility will be sufficient to meet our anticipated cash needs for at least the next 12 months. The timing and amount of our working capital and capital expenditure requirements may vary significantly depending on numerous factors, including:

- market acceptance of our products;
- the need to adapt to changing technologies and technical requirements;
- the existence of opportunities for expansion; and
- access to and availability of sufficient management, technical, marketing and financial personnel.

If our capital resources are insufficient to satisfy our liquidity requirements, we may seek to sell additional equity securities or debt securities or obtain debt financing. The sale of additional equity securities or convertible debt securities would result in additional dilution to our stockholders. Additional debt would result in increased expenses and could result in covenants that would restrict our operations. We have not made arrangements to obtain additional financing and there is no assurance that financing, if required, will be available in amounts or on terms acceptable to us, if at all.

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Delaware law and our corporate charter and bylaws contain anti-takeover provisions that could delay or discourage takeover attempts that stockholders may consider favorable.

Provisions in our certificate of incorporation may have the effect of delaying or preventing a change of control or changes in our management. These provisions include the following:

- the right of the board of directors to elect a director to fill a vacancy created by the expansion of the board of directors;
- the establishment of a classified board of directors requiring that not all members of the board be elected at one time;
- the prohibition of cumulative voting in the election of directors which would otherwise allow less than a majority of stockholders to elect director candidates;
- the requirement for advance notice for nominations for election to the board of directors or for proposing matters that can be acted upon at a stockholders meeting;
- the ability of the board of directors to alter our bylaws without obtaining stockholder approval;
- the ability of the board of directors to issue, without stockholder approval, up to 10,000,000 shares of preferred stock with terms set by the board of directors, which rights could be senior to those of common stock;
- the required approval of holders of at least two-thirds of the shares entitled to vote at an election of directors to adopt, amend or repeal our bylaws or amend or repeal the provisions of our certificate of incorporation regarding the election and removal of directors and the ability of stockholders to take action;
- the required approval of holders of at least two-thirds of the shares entitled to vote at an election of directors to remove directors for cause; and
- the elimination of the right of stockholders to call a special meeting of stockholders and to take action by written consent.

In addition, because we are incorporated in Delaware, we are governed by the provisions of Section 203 of the Delaware General Corporation Law. These provisions may prohibit large stockholders, in particular those owning 15% or more of our outstanding voting stock, from merging or combining with us. These provisions in our certificate of incorporation, bylaws and under Delaware law could discourage potential takeover attempts and could reduce the price that investors might be willing to pay for shares of our common stock in the future and result in the market price being lower than they would without these provisions.

Item 3. *Quantitative and Qualitative Disclosures About Market Risk*

The primary objectives of our investment activity are, in order of importance, to preserve principal, provide liquidity and maximize the income without significantly increasing the risk. Some of the securities we invest in are subject to market risk. This means that a change in prevailing interest rates may cause the principal amount of the investment to fluctuate. To minimize this risk, we maintain our portfolio of cash equivalents and short-term investments in a variety of securities, including commercial paper, money market funds, government and non-government debt securities and certificates of deposit. The risk associated with fluctuating interest rates is limited to our investment portfolio and we do not believe that a 10% change in interest rates will have a significant impact on the fair value of our investment portfolio or on our interest income. As of March 31, 2005, our investments were in money market funds, commercial paper, corporate notes, market auction preferred stock and U.S. government securities.

Our exposure to market risk also relates to the increase or decrease in the amount of interest we must pay on our outstanding debt instruments, primarily certain borrowings under the revolving credit facility. Our revolving credit facility provides financing up to $10.0 million for working capital requirements. As of March 31, 2005, no balances were outstanding under the revolving credit facility. The loan bears interest at the bank s prime rate. We do not believe that a 10% change in the prime rate would have a significant impact on our interest expense.

To date, our international customer agreements have been denominated solely in U.S. dollars, and accordingly, we have not been exposed to foreign currency exchange rate fluctuations related to customer agreements, and do not currently engage in foreign currency hedging transactions. However, the functional currency of our international operations is the U.S. dollar and as the local expenditures are denominated in the respective local currencies, we are subject to foreign currency exchange rate fluctuations associated with remeasurement to U.S dollars. A hypothetical change of 10% in the foreign currency exchange rates would not have a material impact on our consolidated financial position or results of operations.

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Item 4. ***Controls and Procedures***

(a) ***Evaluation of disclosure controls and procedures.*** We maintain disclosure controls and procedures, as such term is defined in Rule 13a-15(e) under the Securities Exchange Act of 1934 (the Exchange Act), that are designed to ensure that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in Securities and Exchange Commission rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating our disclosure controls and procedures, management recognized that disclosure controls and procedures, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the disclosure controls and procedures are met. Our disclosure controls and procedures have been designed to meet, and management believes that they meet, reasonable assurance standards. Additionally, in designing disclosure controls and procedures, our management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible disclosure controls and procedures. The design of any disclosure controls and procedures also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions.

Based on their evaluation as of the end of the period covered by this quarterly report on Form 10-Q, our Chief Executive Officer and Chief Financial Officer have concluded that, subject to the limitations noted above, our disclosure controls and procedures were effective to ensure that material information relating to us, including our consolidated subsidiaries, is made known to them by others within those entities, particularly during the period in which this quarterly report on Form 10-Q was being prepared.

(b) ***Changes in internal control over financial reporting.*** There was no change in our internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) identified in connection with the evaluation described in Item 4 above that occurred during the period covered by this quarterly report that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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PART II - OTHER INFORMATION

Item 1. ***Legal Proceedings.***

We are not involved in any legal matters that management believes will have a material adverse effect on our business. Many companies in the semiconductor, networking, software and related industries have a significant number of patents and have demonstrated a willingness to instigate litigation based on allegations of patent, trademark and other claims of infringement. From time to time, we have received, and expect to continue to receive, notices of claims of infringement, misappropriation or misuse of other parties proprietary rights. Some of these claims may lead to litigation.

Item 2. ***Unregistered Sales of Equity Securities and Use of Proceeds.***

(a) Not applicable

(b) On February 18, 2004, we completed an initial public offering of 10,350,000 shares of our common stock. The shares of common stock sold in the offering were registered under the Securities Act of 1933 on a Registration Statement on Form S-1 (No. 333-110807). The Registration Statement was declared effective by the Securities and Exchange Commission on February 11, 2004. The initial public offering price was $14.00 per share, and the aggregate gross proceeds to us were $144.9 million. After deducting the underwriting discounts and commissions of $10.1 million and the offering expenses of approximately $1.6 million, the net proceeds to us from the offering were approximately $133.2 million.

From February 11, 2004, until March 31, 2005, we used the following net proceeds from the offering: In February 2004, we used $5.8 million of the net offering proceeds to repay debt owed to Silicon Valley Bank, and we have used a total of $7.4 million to fund working capital requirements. We continue to invest the remaining proceeds in short-term, investment grade, interest-bearing instruments.

(c) Not applicable

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Item 6. ***Exhibits.***

Exhibit Number	Description
10.1	Lease Agreement, dated as of April 8, 2005, between the Registrant and Prentiss Properties Acquisition Partners, L.P. (filed as Exhibit 10.1 to the Registrant s Current Report on Form 8-K, filed on April 18, 2005, and incorporated herein by reference).
10.2	Form of restricted stock agreement under 2004 Stock Incentive Plan.
10.3	Summary of 2005 Executive Bonus Plan, adopted by the Compensation Committee of the Board of Directors on March 23, 2005.
31.1	Certification of Chief Executive Officer pursuant to Securities Exchange Act Rules 13a-15(e) and 15d-15(e), as adopted pursuant to the Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Chief Financial Officer pursuant to Securities Exchange Act Rules 13a-15(e) and 15d-15(e), as adopted pursuant to the Section 302 of the Sarbanes-Oxley Act of 2002.
32.1 (1)	Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2 (1)	Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

(1) The material contained in Exhibit 32.1 and Exhibit 32.2 is not deemed filed with the SEC and is not to be incorporated by reference into any filing of the Company under the Securities Act of 1933 or the Securities Exchange Act of 1934, whether made before or after the date hereof and irrespective of any general incorporation language contained in such filing, except to the extent that the registrant specifically incorporates it by reference.

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SIGNATURES

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.

Date: May 16, 2005

ATHEROS COMMUNICATIONS, INC.

/s/ Craig H. Barratt

Craig H. Barratt
Chief Executive Officer and President

(Principal executive officer)

/s/ Jack R. Lazar

Jack R. Lazar
Vice President and Chief Financial Officer
(Duly authorized officer and principal financial and accounting officer)

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