

CONEXANT SYSTEMS INC

Form 10-Q

February 08, 2005

Table of Contents

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

FORM 10-Q

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

For the quarterly period ended December 31, 2004

OR

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

Commission file number: 000-24923

CONEXANT SYSTEMS, INC.

(Exact name of registrant as specified in its charter)

Delaware

25-1799439

(State of incorporation)

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

**4000 MacArthur Boulevard
Newport Beach, California 92660-3095**
(Address of principal executive offices) (Zip code)

(949) 483-4600
(Registrant's telephone number, including area code)

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

Yes ☐ No ○

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

Yes ☐ No ○

Number of shares of registrant's common stock outstanding as of January 28, 2005 was 469,728,299.

Table of Contents

CAUTIONARY STATEMENT

This Quarterly Report on Form 10-Q contains statements relating to future results of Conexant Systems, Inc. (including certain projections and business trends) that are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, and are subject to the safe harbor created by those sections. Our actual results may differ materially from those projected as a result of certain risks and uncertainties. These risks and uncertainties include, but are not limited to: the substantial losses the company has incurred recently; the cyclical nature of the semiconductor industry and the markets addressed by the company's and its customers' products; demand for and market acceptance of new and existing products; successful development of new products; the timing of new product introductions and product quality; the company's ability to anticipate trends and develop products for which there will be market demand; the availability of manufacturing capacity; pricing pressures and other competitive factors; changes in product mix; product obsolescence; the ability to develop and implement new technologies and to obtain protection of the related intellectual property; the uncertainties of litigation and the demands it may place on the time and attention of company management; and the risk that the businesses of Conexant and GlobespanVirata have not yet been completely and may not be integrated successfully, as well as other risks and uncertainties, including those set forth herein and those detailed from time to time in our filings with the Securities and Exchange Commission. These forward-looking statements are made only as of the date hereof, and we undertake no obligation to update or revise the forward-looking statements, whether as a result of new information, future events or otherwise.

Table of Contents

CONEXANT SYSTEMS, INC.

INDEX

	PAGE
<u>PART I. FINANCIAL INFORMATION</u>	
<u>Item 1. Financial Statements (unaudited):</u>	
<u>Consolidated Condensed Balance Sheets December 31, 2004 and September 30, 2004</u>	4
<u>Consolidated Condensed Statements of Operations Three Months Ended December 31, 2004 and 2003</u>	5
<u>Consolidated Condensed Statements of Cash Flows Three Months Ended December 31, 2004 and 2003</u>	6
<u>Notes to Consolidated Condensed Financial Statements</u>	7
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	26
<u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>	47
<u>Item 4. Controls and Procedures</u>	48
<u>PART II. OTHER INFORMATION</u>	
<u>Item 1. Legal Proceedings</u>	49
<u>Item 6. Exhibits</u>	49
<u>Signature</u>	50
<u>EXHIBIT 31.1</u>	
<u>EXHIBIT 31.2</u>	
<u>EXHIBIT 32</u>	
<u>EXHIBIT 99</u>	

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

	December 31, 2004	September 30, 2004
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 132,326	\$ 139,031
Short-term investments	135,597	163,040
Receivables, net of allowance of \$5,478 and \$5,974 at December 31, 2004 and September 30, 2004, respectively	92,864	185,037
Inventories	136,438	194,754
Mindspeed warrant-current portion	5,634	3,599
Other current assets	17,521	20,768
Total current assets	520,380	706,229
Property, plant and equipment, net	53,266	55,741
Goodwill	714,852	708,544
Intangible assets, net	128,947	135,241
Mindspeed warrant	35,737	23,000
Marketable securities	123,266	137,604
Other assets	112,936	114,163
Total assets	\$ 1,689,384	\$ 1,880,522
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable	\$ 89,171	\$ 141,533
Accrued compensation and benefits	44,511	40,423
Restructuring and reorganization liabilities	28,205	22,427
Other current liabilities	51,502	67,044
Total current liabilities	213,389	271,427
Convertible subordinated notes	711,825	711,825
Other liabilities	64,741	68,883
Total liabilities	989,955	1,052,135
Commitments and contingencies		

Shareholders equity:

Preferred and junior preferred stock		
Common stock, \$0.01 par value: 1,000,000 shares authorized; 469,722 and 469,441 shares issued, and 468,538 shares and 468,257 shares outstanding at December 31, 2004 and September 30, 2004, respectively	4,697	4,694
Treasury stock: 1,184 shares at cost	(5,584)	(5,584)
Additional paid-in capital	4,651,343	4,648,325
Accumulated deficit	(3,997,894)	(3,877,176)
Accumulated other comprehensive income	68,802	82,551
Notes receivable from stock sales	(386)	(576)
Unearned compensation	(21,549)	(23,847)
Total shareholders equity	699,429	828,387
Total liabilities and shareholders equity	\$ 1,689,384	\$ 1,880,522

See accompanying notes to consolidated condensed financial statements.

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

	Three months ended December 31,	
	2004	2003
Net revenues	\$ 140,621	\$ 177,333
Cost of goods sold	133,465	98,196
Gross margin	7,156	79,137
Operating expenses:		
Research and development (including non-cash stock compensation of \$2,245 and \$23 for the three months ended December 31, 2004 and 2003, respectively)	72,541	39,154
Selling, general and administrative (including non-cash stock compensation of \$744 and \$0 for the three months ended December 31, 2004 and 2003, respectively)	30,006	22,809
Amortization of intangible assets	8,293	955
Special charges	19,257	605
Total operating expenses	130,097	63,523
Operating income (loss)	(122,941)	15,614
Other (income) expense, net	(2,755)	(25,281)
Income (loss) before income taxes	(120,186)	40,895
Provision for income taxes	532	248
Net income (loss)	\$ (120,718)	\$ 40,647
Net income (loss) per share basic	\$ (0.26)	\$ 0.15
Net income (loss) per share diluted	\$ (0.26)	\$ 0.13
Number of shares used in per share computation-basic	468,369	277,190
Number of shares used in per share computation-diluted	468,369	307,545

See accompanying notes to consolidated condensed financial statements.

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

	Three months ended December 31,	
	2004	2003
Cash flows from operating activities:		
Net income (loss)	\$ (120,718)	\$ 40,647
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities, net of effects of acquisition:		
Depreciation	4,838	3,155
Amortization of intangible assets	8,293	955
Reduction of provision for bad debt	(500)	
Inventory provisions	45,001	1,644
Increase in fair value of Skyworks note and Mindspeed warrant	(14,773)	(19,719)
Equity in losses (earnings) of equity method investees	3,089	(10,165)
Stock compensation, option modification charges and other	2,989	
Other non-cash items, net	(95)	504
Changes in assets and liabilities:		
Receivables	92,824	(6,057)
Inventories	13,427	(1,075)
Accounts payable	(53,016)	12,074
Agere patent litigation settlement	(8,000)	
Special charges, net of \$10.6 million and \$2.3 million of payments, respectively	8,632	(1,672)
Accrued expenses and other current liabilities	(1,291)	5,270
Other	3,250	(2,976)
Net cash provided by (used in) operating activities	(16,050)	22,585
Cash flows from investing activities:		
Cash paid for acquisition, net of cash acquired	(14,501)	
Purchases of marketable securities	(7,080)	(12,580)
Sales of marketable securities	34,170	8,266
Capital expenditures	(2,082)	(4,857)
Deferred merger costs		(1,432)
Payment of deferred purchase consideration		(4,000)
Investments in businesses	(1,755)	(471)
Net cash provided by (used in) investing activities	8,752	(15,074)
Cash flows from financing activities:		
Proceeds from exercise of stock options	397	6,065

Edgar Filing: CONEXANT SYSTEMS INC - Form 10-Q

Repayment of notes receivable from stock sales	196	
Net cash provided by financing activities	593	6,065
Net increase (decrease) in cash and cash equivalents	(6,705)	13,576
Cash and cash equivalents at beginning of period	139,031	76,186
Cash and cash equivalents at end of period	\$ 132,326	\$ 89,762

See accompanying notes to consolidated condensed financial statements.

Table of Contents

CONEXANT SYSTEMS, INC.

**NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS
(unaudited)**

1. Basis of Presentation and Significant Accounting Policies

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

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

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

Fiscal Periods For presentation purposes, references made to the periods ended December 31, 2003 and 2004, relate to the actual fiscal 2004 first quarter ended January 2, 2004 and the actual first fiscal quarter of 2005 ended December 31, 2004.

Supplemental Cash Flow Information Cash paid for interest was \$4.8 million and \$1.4 million for the three months ended December 31, 2004 and 2003, respectively. Cash paid for income taxes for the three months ended December 31, 2004 and 2003 was \$0.3 million and \$0.6 million, respectively.

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

Conexant has more than 20 distributor customers for whom revenue is recognized upon its shipment of product to them, as the contractual terms provide for no rights of return. During the first fiscal quarter of 2005, the Company

made a business decision to assist primarily three distribution customers to more rapidly sell their inventory by accepting net product returns of \$13.3 million and making price adjustments of \$7.9 million on certain of their products in inventory. As a result of implementing these returns and adjustments, which are a departure from the contractual terms with these customers, the Company has decided that it is appropriate to defer the recognition of revenue on sales to these three distributors until the purchased products are sold by the distributors to a third party.

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

Table of Contents

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

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

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

	Three months ended December 31,	
	2004	2003
Numerator (dollars in thousands):		
Net income (loss)- basic	\$ (120,718)	\$ 40,647
Effect of assumed conversion of 4.25% Convertible Subordinated Notes due 2006		439
Net income (loss)- diluted	\$ (120,718)	\$ 41,086
Denominator (weighted-average number of shares in thousands):		
Weighted average shares outstanding- basic	468,369	277,190
Stock options and warrants (under the treasury stock method)		22,973
Restricted stock		18
Assumed conversion of 4.25% Convertible Subordinated Notes due 2006		7,364
Weighted average shares outstanding - diluted	468,369	307,545

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

	Three months ended December 31,	
	2004	2003
(weighted-average number of shares, in thousands)		
Stock options and warrants (under the treasury stock method)	1,921	
4.25% Convertible Subordinated Notes due 2006	7,364	
5.25% Convertible Subordinated Notes due 2006	5,840	
4.00% Convertible Subordinated Notes due 2007	12,137	12,137
Restricted stock	6	

Stock-Based Compensation The Company accounts for employee stock-based compensation in accordance with the provisions of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB 25) and therefore no compensation expense has been recognized for fixed stock option plans as options are granted at fair market value on the date of grant. The Company also has an employee stock purchase plan for all eligible employees. The Company has adopted the pro forma disclosure provisions of Statement of Financial Accounting Standards (SFAS) No. 123, Accounting for Stock-Based Compensation, as amended by SFAS No. 148, Accounting for

Stock-Based Compensation Transition and Disclosure.

Table of Contents

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

Had stock-based compensation been determined based on the fair value at the grant date for awards consistent with the provisions of SFAS No. 123, the Company's pro forma net income (loss) and pro forma net income (loss) per share would have been the amounts indicated below (in thousands, except per share amounts):

	Three months ended December 31,	
	2004	2003
Net income (loss), as reported	\$ (120,718)	\$ 40,647
Add: expense determined under fair value accounting included in net income (loss), as reported	2,989	23
Deduct: total expense determined under fair value accounting for all awards	(18,566)	(13,130)
Pro forma net income (loss)	\$ (136,295)	\$ 27,540
Net income (loss) per share - basic, as reported	\$ (0.26)	\$ 0.15
Pro forma net income (loss) per share - basic	\$ (0.29)	\$ 0.10
Net income (loss) per share - diluted, as reported	\$ (0.26)	\$ 0.13
Pro forma net income (loss) per share - diluted	\$ (0.29)	\$ 0.10

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

	Three months ended December 31,	
	2004	2003
Risk-free interest rate	3.6%	3.3%
Expected volatility	97%	97%
Dividend yield		
Expected life (years)	4.5	4.5
Weighted-average fair value of options granted	\$ 1.58	\$ 4.23

The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions, including the expected stock price volatility. Because awards held by employees and directors have characteristics significantly different from those of traded options, and because changes in the subjective input assumptions can materially affect the fair value estimate, in the opinion of management, the existing models do not necessarily provide a reliable single measure of the fair value of these options.

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

Recent Accounting Pronouncements In December 2004, the Financial Accounting Standards Board issued SFAS No. 123 (R), *Share-Based Payment*. This pronouncement amends SFAS No. 123, and supersedes APB Opinion No. 25. SFAS No. 123 (R) requires that public companies account for awards of equity instruments issued to employees under the fair value method of accounting and recognize such amounts in the statement of operations. This statement is effective beginning with the Company's fiscal 2005 fourth quarter beginning July 2, 2005. The Company expects the impact of this new pronouncement to be significant to its results of operations.

Cash, Cash Equivalents and Investments - marketable securities The Company considers all highly liquid investments with insignificant interest rate risk and original maturities of three months or less from the date of purchase to be cash equivalents. The carrying amounts of cash and cash equivalents approximate their fair values. Short-term marketable securities consist of mutual funds, debt securities with original maturity dates between ninety days and one year, and equity securities. Long-term marketable securities consist of debt securities with original

Table of Contents

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

maturity dates greater than one year. The Company's investments are classified as available-for-sale, and are reported at fair value at the balance sheet date. The unrealized gains and losses are reported as a component of accumulated other comprehensive income (loss). Management determines the appropriate classification of debt securities at the time of purchase and reassesses the classification at each reporting date. Gains and losses on the sale of available-for-sale investments are determined using the specific-identification method.

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

Total cash, cash equivalents and marketable securities at December 31, 2004 and at September 30, 2004 are as follows (in thousands):

	December 31, 2004	September 30, 2004
Cash and cash equivalents	\$ 132,326	\$ 139,031
Equity securities- Skyworks Solutions, Inc. (6.2 million shares at December 31, 2004 and September 30, 2004)	58,305	61,767
Equity securities- SiRF Technologies, Inc. (5.9 million shares at December 31, 2004 and September 30, 2004)	74,705	87,509
Other short-term marketable securities (primarily mutual funds, domestic government agency securities and corporate debt securities)	2,587	13,764
Subtotal- short-term investments	135,597	163,040
Long-term marketable securities (primarily domestic government agency securities and corporate debt securities)	123,266	137,604
Total cash, cash equivalents and marketable securities	\$ 391,189	\$ 439,675

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

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

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

The consideration for this purchase was \$14.8 million in cash. Net tangible assets acquired were \$0.4 million. Approximately \$0.7 million of the purchase price was allocated to unearned compensation representing the intrinsic value of unvested stock options exchanged in the transaction and the remainder to identifiable intangible assets and goodwill. The unearned compensation will be amortized to expense over the four year remaining vesting period of the stock options. The identifiable intangible assets of \$2.0 million are being amortized on a straight-line basis over five years. The amount recorded as goodwill of \$11.7 million is not deductible for tax purposes. The purchase price allocation is preliminary and is subject to change pending finalization of a third party valuation report of acquired identifiable intangible assets.

The pro forma effect of this acquisition was not material to the Company's results of operations for fiscal 2005 or 2004.

Table of Contents

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

Merger with GlobespanVirata, Inc.

On February 27, 2004, the Company completed its merger with GlobespanVirata, with GlobespanVirata becoming a wholly-owned subsidiary of the Company. For accounting purposes, the transaction was accounted for under the purchase method of accounting with the Company as the acquirer. In exchange for 100% of the outstanding shares of common stock of GlobespanVirata (approximately 150.7 million shares), the Company issued 1.198 shares of Conexant common stock for each share of GlobespanVirata common stock outstanding (or approximately 180.6 million shares of Conexant common stock) and each outstanding option and warrant to purchase GlobespanVirata common stock was adjusted and converted into an option or warrant to purchase Conexant common stock based on the 1.198 merger ratio (or approximately 43.6 million options to purchase shares of Conexant common stock). In May 2004, the GlobespanVirata, Inc. subsidiary was renamed Conexant, Inc., and hereinafter will be referred to as Conexant, Inc., and the overall business combination is hereinafter referred to as the Merger.

The purchase consideration is summarized as follows (in thousands):

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

The fair value of Conexant common stock and stock options issued of \$1.1 billion has been allocated to common stock and additional paid in capital. The fair market value of the 180.6 million shares of common stock issued was determined using a per share price of \$5.69 (the average of the closing market prices of Conexant common stock on the day of the announcement of the Merger, November 3, 2003, and on the three business days before and after the announcement date). In accordance with FASB Interpretation No. 44 Accounting for Certain Transactions Involving Stock Compensation, the \$111.9 million fair value of the 43.6 million Conexant common stock options granted to replace the acquired common stock options was determined using a Black-Scholes option pricing model with the following assumptions: market price of \$5.69 per share, volatility of 97%, risk-free rate of return of 3.2%, expected lives of 4.5 years and no dividend yield. Approximately \$30.9 million in intrinsic value associated with the unvested stock options has been allocated to unearned compensation and will be amortized to expense over the average remaining vesting period of approximately 2.6 years. A total of \$3.0 million of this unearned compensation was recognized as an expense in the three months ended December 31, 2004.

In connection with the Merger, the Company began to formulate a reorganization and restructuring plan (the Reorganization Plan). As a result of the Reorganization Plan, through September 30, 2004, the Company recognized an aggregate of \$11.5 million as liabilities assumed in the purchase business combination related to restructuring liabilities for estimated costs related to Conexant, Inc. facilities consolidation and the related impact on Conexant, Inc. outstanding real estate leases and Conexant, Inc. involuntary employee terminations and relocations. These liabilities were included in the allocation of the purchase price in accordance with SFAS No. 141 entitled Business Combinations and EITF 95-3 entitled Recognition of Liabilities in Connection with a Purchase Business Combination. The Reorganization Plan was complete as of December 31, 2004 and no adjustments were made to goodwill for these actions during the first fiscal quarter of 2005.

In the Merger, the Company acquired a reserve for income tax contingencies for foreign income tax matters which arose due to items recorded in the income tax returns of the former GlobespanVirata subsidiaries. As of September 30, 2004, this reserve balance was \$8.2 million. In the quarter ended December 31, 2004, a portion of this income tax contingency was settled with the taxing authorities, and as a result, the amount of the liability in excess of the settlement amount of \$5.4 million was reduced with a corresponding reduction to goodwill. As the remaining pre-acquisition contingencies continue to evolve and settle with the taxing authorities, the Company will record such changes, favorable or unfavorable, against the purchase price allocation (goodwill) through the expiration of the allocation period (the end of the fiscal 2005 second quarter) as defined by SFAS No. 141. If the contingencies are not settled by the end of the fiscal 2005 second quarter, any changes after that date, whether favorable or unfavorable, will be recorded to operations.

Table of Contents

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

The following sets forth the Company's estimates of the fair values of the assets acquired and liabilities assumed in the Merger (in thousands). The amounts below may change further through the end of the allocation period.

Cash and cash equivalents	\$ 42,515
Short-term and long-term investments	153,099
Accounts receivable	91,259
Inventories	73,281
Prepays and other current assets	4,236
Property and equipment	46,883
Other long-term assets	20,600
Identifiable intangible assets	137,931
In-process research and development	160,818
Goodwill	626,981
Accounts payable	(41,580)
Accrued expenses	(72,626)
Accrued restructuring and reorganization liabilities	(11,465)
Long-term debt	(130,000)
Other long-term liabilities	(23,284)
Treasury stock	9,188
Notes receivable from stock sales	2,469
Unearned compensation	30,948
Net assets acquired	\$ 1,121,253

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

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

The identifiable intangible assets were valued using the income approach and a discount rate of 18%. The developed technologies consist of eight products in the digital subscriber line (DSL) and wireless local area network (LAN) categories. Under the income approach, the fair value reflects the present value of the projected cash flows that are expected to be generated by the products incorporating the current technology. The type of income approach utilized for the trademark was the relief from royalty methodology, under which an estimate is made as to the appropriate royalty income that would be negotiated in an arm's length transaction if the subject intangible asset were licensed from an independent third party owner. These assets are being amortized on a straight-line basis over their

estimated useful lives ranging from 2 to 7 years, with a weighted-average life of approximately 5 years. Amortization expense for these intangible assets was \$6.9 million for the three months ended December 31, 2004. The Company does not believe that any indicator of permanent impairment exists with respect to the identifiable intangible assets. The Company continues to evaluate the indicators of impairment and if such indicators are determined to exist, the Company will formally evaluate the recoverability of these assets. The amount recorded as goodwill of \$627.0 million is not deductible for tax purposes.

The amount allocated to in process research and development (IPR&D) of \$160.8 million was expensed upon completion of the Merger (as a charge not deductible for tax purposes) as it was determined that the underlying products had not reached technological feasibility, had no alternative uses and successful development was uncertain. The Company identified and valued two IPR&D projects relating to the development of DSL and wireless networking products. The DSL project represented 70% of the total IPR&D acquired. Both projects were approximately 87% complete at the date of the merger. The estimated costs to complete for the DSL and wireless networking projects were approximately \$14.1 million and \$6.2 million, respectively. These projects are planned to be completed in fiscal 2005. The fair values assigned to these projects were based on the income approach and used projected cash flows which were discounted at a rate of 19%. The discount rate was derived from a weighted-

Table of Contents

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

average cost of capital analysis, adjusted upwards to reflect additional risks inherent in the development process, including the probability of achieving technological success and market acceptance. Each of the IPR&D projects was analyzed considering technological innovations, the existence and utilization of core technology, the complexity, costs and time to complete the remaining development efforts, and stage of completion. The discount rate reflects the stage of completion and other risks inherent in the projects. The material risks associated with the incomplete projects are the ability to complete the items within the outlined timeframes and within the allocated cost guidelines, and ultimately to sell the products to end-users.

Management is responsible for the amounts determined for IPR&D as well as developed technologies and believes that these amounts are representative of fair values. Actual results do not differ materially from the estimates used in the valuation of IPR&D.

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

The Merger was accounted for as a purchase and the operating results of the former GlobespanVirata have been included in the Company's operations from the closing date. The following unaudited pro forma information represents a summary of the results of operations as if the Merger occurred at the beginning of the period presented and includes amortization of identifiable intangibles and unearned compensation from that date.

	Three months ended Dec. 31, 2003
Net revenues	\$ 314,581
Net income	\$ 38,633
Net income per common share basic	\$ 0.08
Net income per common share diluted	\$ 0.08

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

Acquisition of Amphion Semiconductor

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

Under the stock purchase agreement, the Company guaranteed the value of the shares issued to the former Amphion shareholders for a defined period through June 29, 2006 (subject to certain conditions and elections). The guaranty is subject to adjustment for any stock split, stock dividend, recapitalization, merger or similar transaction. In the event that the market price of the Conexant common stock does not equal or exceed \$10.00 for at least five consecutive trading days during this period, Conexant would be required to make an additional payment (in cash or additional shares of common stock at Conexant's option) to former Amphion shareholders for the difference between the \$10.00 and the market price per share of such shares as of specified dates. Consequently, the Company has valued the shares delivered to the former Amphion shareholders at the guaranteed value of \$10.00 per share, or a total of \$6.0 million. To the extent the Company is required to make an additional payment under the guaranty, the payment will not increase the total purchase price.

The terms of this acquisition include provisions under which the former shareholders of Amphion could receive additional consideration of up to \$4.0 million during the twelve to eighteen months following the acquisition if

Table of Contents

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

certain technology milestones are achieved. This contingent consideration has not been included in the purchase price allocation and if earned, such amounts will be capitalized as an addition to goodwill.

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

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

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

Short-term investments (in thousands):

	Amortized Cost	Gross Unrealized Holding Gains	Gross Unrealized Holding Losses	Fair Value
December 31, 2004:				
Corporate debt securities	\$ 1,405	\$	\$ (2)	\$ 1,403
Equity securities	56,524	77,670		134,194
	\$ 57,929	\$ 77,670	\$ (2)	\$ 135,597
September 30, 2004:				
Mutual funds	\$ 10,837	\$	\$ (125)	\$ 10,712
Corporate debt securities	2,274		(3)	2,271
Equity securities	56,524	93,533		150,057
	\$ 69,635	\$ 93,533	\$ (128)	\$ 163,040

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

Long-term investments (in thousands):

	Amortized Cost	Gross Unrealized Holding Gains	Gross Unrealized Holding Losses	Fair Value
December 31, 2004:				
Domestic government agency securities	\$ 88,738	\$	\$ (434)	\$ 88,304

Corporate debt securities	35,202	3	(243)	34,962
	\$ 123,940	\$ 3	\$ (677)	\$ 123,266

September 30, 2004:

Domestic government agency securities	\$ 105,956	\$	\$ (800)	\$ 105,156
Corporate debt securities	32,595		(147)	32,448
	\$ 138,551	\$	\$ (947)	\$ 137,604

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

Inventories

Inventories consist of the following (in thousands):

	December 31, 2004	September 30, 2004
Work-in-process	\$ 70,785	\$ 99,226
Finished goods	65,653	95,528
	\$ 136,438	\$ 194,754

At December 31, 2004 and September 30, 2004, inventories are net of \$49.5 million and \$23.3 million, respectively, of allowances for excess and obsolete inventories. In addition, at December 31, 2004, inventories are net of \$18.8 million in lower of cost or market reserves.

In the quarter ended December 31, 2004, in response to lower market prices and reduced end-customer demand for Broadband Access and Wireless Networking products, the Company recorded \$26.2 million in excess and obsolete charges and \$18.8 million of charges to reduce certain Wireless Networking inventory to its estimated lower of cost or market value.

Table of Contents

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

Goodwill

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

Goodwill, September 30, 2004	\$ 708,544
Acquisition of Paxonet	11,731
Adjustments to prior purchase price allocation (1)	(5,423)
Goodwill, December 31, 2004	\$ 714,852

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

Intangible Assets

Intangible assets consist of the following (in thousands):

	December 31, 2004			September 30, 2004		
	Gross Asset	Accumulated Amortization	Net	Gross Asset	Accumulated Amortization	Net
Developed technology	\$ 145,946	\$ (32,659)	\$ 113,287	\$ 145,946	\$ (25,359)	\$ 120,587
Customer base	4,050	(1,052)	2,998	2,050	(847)	1,203
Other intangible assets	20,908	(8,246)	12,662	20,908	(7,457)	13,451
	\$ 170,904	\$ (41,957)	\$ 128,947	\$ 168,904	\$ (33,663)	\$ 135,241

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

	Remainder of					
	2005	2006	2007	2008	2009	Thereafter
Amortization expense	\$ 23,651	\$ 30,301	\$ 29,569	\$ 29,114	\$ 13,611	\$ 2,701

Mindspeed Warrant

The Company accounts for the Mindspeed warrant as a derivative instrument, and changes in the fair value of the warrant are included in other (income) expense, net each period. At December 31, 2004, the aggregate fair value of the Mindspeed warrant included on the accompanying consolidated condensed balance sheet was \$41.4 million. The

current portion of \$5.6 million was determined using current pricing data, and the remaining portion was valued using a Black-Scholes model with terms for portions of the warrant varying from 1 to 5 years, volatility of 90%, a risk-free interest rate of 3.2% and no dividend yield. It is the Company's intent to liquidate the portion of this warrant classified as current in the next twelve months.

The valuation of this derivative instrument is subjective, and option valuation models require the input of highly subjective assumptions, including the expected stock price volatility. Changes in these assumptions can materially affect the fair value estimate. The Company could, at any point in time, ultimately realize amounts significantly different than the carrying value.

Table of Contents

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

Convertible Subordinated Notes

At December 31, 2004, the components of convertible subordinated notes are as follows (in thousands):

4.00% Convertible Subordinated Notes due February 2007 with a conversion price of \$42.43	\$ 515,000
4.25% Convertible Subordinated Notes due May 2006 with a conversion price of \$9.08	66,825
5.25% Convertible Subordinated Notes due May 2006 with a conversion price of \$22.26	130,000
 Total convertible subordinated notes	 \$ 711,825

Other (Income) Expense, Net

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

	Three months ended December 31,	
	2004	2003
Investment and interest income	\$ (551)	\$ (2,497)
Decrease in fair value of the conversion right under the Skyworks 15% convertible senior subordinated notes		4,911
Increase in fair value of the Mindspeed warrant	(14,773)	(24,630)
Interest expense	8,431	6,689
Equity in (earnings) losses of equity method investees	3,089	(10,165)
Other	1,049	411
 Other (income) expense, net	 \$ (2,755)	 \$ (25,281)

During the three months ended December 31, 2003, an unrelated party repaid a \$30.0 million note issued in connection with a previous equity investment in Jazz Semiconductor, Inc., in which the Company owns a 38% interest. In accordance with Staff Accounting Bulletin No. 51, the Company recognized an \$11.4 million gain upon the payment of this note, which is included in equity in earnings of equity method investees.

4. Skyworks Notes

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

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

5. Commitments and Contingencies

Legal Matters

Certain claims have been asserted against the Company, including claims alleging the use of the intellectual property rights of others in certain of the Company's products. The resolution of these matters may entail the negotiation of a

Table of Contents

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

license agreement, a settlement, or the adjudication of such claims through arbitration or litigation. The outcome of litigation cannot be predicted with certainty and some lawsuits, claims or proceedings may be disposed of unfavorably to the Company. Many intellectual property disputes have a risk of injunctive relief and there can be no assurance that a license will be granted. Injunctive relief could have a material adverse effect on the financial condition or results of operations of the Company. Based on its evaluation of matters which are pending or asserted and taking into account the Company's reserves for such matters, management believes the disposition of such matters will not have a material adverse effect on the financial condition, results of operations, or cash flows of the Company.

IPO Litigation. In November 2001, Collegeware Asset Management, LP, on behalf of itself and a putative class of persons who purchased Conexant, Inc. common stock between June 23, 1999 and December 6, 2000, filed a complaint in the U.S. District Court for the Southern District of New York alleging violations of federal securities laws by the underwriters of Conexant, Inc.'s initial and secondary public offerings as well as certain Conexant, Inc. officers and directors. The complaint alleges that the defendants violated federal securities laws by issuing and selling Conexant, Inc.'s common stock in the initial and secondary offerings without disclosing to investors that the underwriters had (1) solicited and received undisclosed and excessive commissions or other compensation and (2) entered into agreements requiring certain of their customers to purchase the stock in the aftermarket at escalating prices. The complaint seeks unspecified damages. The complaint was consolidated with approximately 300 other actions making similar allegations regarding the public offerings of hundreds of other companies during 1998 through 2000. In June 2003, the issuers, the individual defendants and plaintiffs reached a tentative settlement agreement that would, among other things, result in the dismissal with prejudice of all claims against Conexant, Inc.'s officers and directors. The settlement remains subject to a number of conditions, including class certification and approval of the settlement by the court. It is possible that the parties will not reach agreement on the final settlement or that the settlement will not be approved. Even if the settlement is approved, individual class members will have an opportunity to opt out of the class and to file their own lawsuits, and some may do so. In either event, the Company believes that the Conexant, Inc. officers and directors have meritorious defenses to the plaintiffs' claims and expects that those defendants will defend themselves vigorously. The Company also believes that it has sufficient insurance coverage to cover any indemnification obligations to the directors and officers related to this litigation.

Texas Instruments, Inc. The Company's Conexant, Inc. subsidiary has been involved in a dispute with Texas Instruments, Inc. (Texas Instruments) over a group of patents (and related foreign patents) that Texas Instruments alleges are essential to certain industry standards for implementing ADSL technology. On June 12, 2003, Conexant, Inc. filed a complaint against Texas Instruments, Stanford University and its Board of Trustees, and Stanford University OTL, LLC (collectively, the Defendants) in the U.S. District Court of New Jersey. The complaint asserts, among other things, that the Defendants have violated the antitrust laws by creating an illegal patent pool, by manipulating the patent process and by abusing the process for setting industry standards related to ADSL technology. The complaint also asserts that the Defendants' patents relating to ADSL are unenforceable, invalid and/or not infringed by Conexant, Inc. products. Conexant, Inc. is seeking, among other things, (i) a finding that the Defendants have violated the federal antitrust laws and treble damages based upon such a finding, (ii) an injunction prohibiting the Defendants from engaging in anticompetitive practices, (iii) a declaratory judgment that the claims of the Defendants ADSL patents are invalid, unenforceable, void, and/or not infringed by Conexant, Inc. and (iv) an injunction prohibiting the Defendants from pursuing patent litigation against Conexant, Inc. and its customers. On August 11, 2003 and September 9, 2003, the Defendants answered the complaint, denied Conexant, Inc.'s claims and filed counterclaims alleging that Conexant, Inc. has infringed certain of their ADSL patents. In addition to other relief, the Defendants are seeking to collect damages for alleged past infringement and to enjoin Conexant, Inc. from continuing to use the Defendant's ADSL patents. Although the Company believes that Conexant, Inc. has strong arguments in

favor of its position in this dispute, it can give no assurance that Conexant, Inc. will prevail on any of these grounds in litigation. If any such litigation is adversely resolved, Conexant, Inc. could be held responsible for the payment of damages and/or future royalties and/or have the sale of certain of Conexant, Inc. products stopped by an injunction, any of which could have a material adverse effect on the Company's business, financial condition and results of operations.

Table of Contents

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

Class Action Suits. In December 2004 and January 2005, the Company and certain current and former officers were named as defendants in several complaints filed on behalf of all persons who purchased Company common stock during a specified class period in the U.S. District Court of New Jersey and the U.S. District Court for the Central District of California, alleging that the defendants violated the Securities Exchange Act of 1934 (the Exchange Act) by allegedly disseminating materially false and misleading statements and/or concealing material adverse facts. The defendants believe these charges are without merit and intend to vigorously defend the litigation.

Shareholder Derivative Suits. In January 2005, the Company and certain current and former directors and officers were named as defendants in purported shareholder derivative actions in California State Court for the County of Orange, alleging that the defendants breached their fiduciary duties, abused control, mismanaged the company, wasted corporate assets and unjustly enriched themselves. The defendants believe these charges are without merit and intend to vigorously defend the litigation.

Agere Systems, Inc. On November 4, 2004, the Company reached a settlement with Agere Systems Inc. (Agere), which among other things, dismissed with prejudice all litigation matters between the two companies. The settlement agreement also provided for the dismissal with prejudice of all claims brought by and against Intersil. Conexant, Inc. (formerly GlobespanVirata, Inc.) acquired the WLAN Group of Intersil in August 2003. As part of this overall litigation settlement, the Company made a cash payment, which was accrued in fiscal 2004, to Agere in the amount of \$8.0 million in November 2004 and the two companies entered into various license agreements covering the patents involved in the suits and other semiconductor devices.

Other

The Company has been designated as a potentially responsible party and is engaged in groundwater remediation at one Superfund site located at a former silicon wafer manufacturing facility and steel fabrication plant in Parker Ford, Pennsylvania formerly occupied by the Company. In addition, the Company is engaged in remediation of groundwater contamination at its former Newport Beach, California wafer fabrication facility. Management currently estimates the aggregate remaining costs for these remediations to be approximately \$3.0 million and has accrued for these costs as of December 31, 2004.

The Company leases certain facilities and equipment under non-cancelable operating leases which expire at various dates through 2021 and contain various provisions for rental adjustments including, in certain cases, adjustments based on increases in the Consumer Price Index. The leases generally contain renewal provisions for varying periods of time. Rental expense under operating leases was approximately \$5.7 million and \$4.4 million for the three months ended December 31, 2004 and 2003, respectively.

At December 31, 2004, future minimum lease payments under operating leases, excluding any sublease income, were as follows (in thousands):

Fiscal Year

2005 remaining 9 months	\$ 21,620
2006	21,445
2007	16,795
2008	12,114

2009	9,172
Thereafter	62,097
Total future minimum lease payments	\$ 143,243

At December 31, 2004, the Company has many sublease arrangements on operating leases for terms ranging from near term to approximately 6 years. Aggregate scheduled sublease income based on current terms is approximately \$7.5 million.

The summary of future minimum lease payments includes an aggregate gross amount of \$44.7 million of lease obligations that principally expire through fiscal 2021, which have been accrued for in connection with the

Table of Contents

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

Company's reorganization and restructuring actions (see Note 7) and previous actions taken by GlobespanVirata prior to the Merger.

The Company purchases a portion of its requirements for silicon-based semiconductor products from Jazz Semiconductor, Inc. (Jazz). In the event the Company's actual wafer purchases are less than the required minimum volumes, it will be required to make additional payments to Jazz. The Company's expected minimum purchase obligations under the supply agreement with Jazz, net of a portion of the wafer purchase obligations assumed by a third party, will be approximately \$7.0 million for the remainder of fiscal year 2005. The Company is contingently liable for the approximate \$6.0 million in the minimum purchase obligations assumed by that third party.

Additionally, the Company entered into a supply agreement with Skyworks in June 2002, under which Skyworks provides semiconductor assembly and test services at the Company's former Mexicali, Mexico facility. Under this supply agreement, the Company is obligated to purchase certain minimum amounts of assembly and test services for the remainder of fiscal 2005 in the amount of \$7.2 million. In the event the Company's purchases of assembly and test services are less than the required minimum amounts, it will be required to make additional payments to Skyworks.

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

At December 31, 2004, the Company is contingently liable for approximately \$14.6 million in operating lease commitments on facility leases that were assigned to Mindspeed and Skyworks at the time of their separation from the Company.

In connection with certain non-marketable equity investments, the Company may be required to invest up to an additional \$4.4 million as of December 31, 2004.

The Company has exercised its purchase option for approximately \$60.0 million to purchase two buildings in Newport Beach, California which are currently occupied under a lease agreement. The Company's plan is to complete a sale-leaseback transaction with respect to these facilities in the quarter ending March 31, 2005.

The Company has made commitments to certain employees in the amount of \$4.6 million as of December 31, 2004. Such amounts will be earned and paid over the next twelve months.

6. Comprehensive Income (Loss)

Comprehensive income (loss) is as follows (in thousands):

	Three months ended December 31,	
	2004	2003
Net income (loss)	\$(120,718)	\$ 40,647
Other comprehensive income (loss):		
Foreign currency translation adjustments	1,628	458

Edgar Filing: CONEXANT SYSTEMS INC - Form 10-Q

Change in unrealized gains on available-for-sale securities	(15,464)	(451)
Minimum pension liability adjustments	87	86
Effect of income taxes		172
Other comprehensive income (loss)	(13,749)	265
Comprehensive income (loss)	\$ (134,467)	\$ 40,912

Table of Contents

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

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

	December 31, 2004	September 30, 2004
Foreign currency translation adjustments	\$ (1,578)	\$ (3,206)
Unrealized gains on available-for-sale securities	76,994	92,458
Minimum pension liability adjustments	(6,614)	(6,701)
Accumulated other comprehensive income	\$ 68,802	\$ 82,551

7. Special Charges

Special charges consist of the following (in thousands):

	Three months ended December 31,	
	2004	2003
Asset impairments	\$ 455	\$ 153
Restructuring charges	11,971	448
Integration charges	3,525	
Other	3,306	4
	\$ 19,257	\$ 605

Asset Impairments

During the first fiscal quarter of 2005, the Company recorded asset impairment charges of \$0.5 million related to various operating assets which were determined to be redundant and no longer required as a result of restructuring activities. These assets have been abandoned.

Restructuring Charges

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

have been recorded as acquired liabilities in the Merger and included as part of the purchase price allocation in accordance with EITF 95-3 and SFAS No. 141 (see Note 2). Subsequent actions that impacted the employees and facilities of Conexant, Inc. have been included in special charges on the Company's statements of operations.

2005 Restructuring Action In November 2004, the Company announced additional plans to reduce its operating expense level by the end of the fourth fiscal quarter of 2005. The components of this plan are a shift of product development resources to lower-cost regions and cost savings from continued Merger-related sales, general and administrative consolidation. During the first fiscal quarter of 2005, the Company completed numerous senior management changes and notified an additional 13 employees in selling, general and administrative areas of their involuntary termination. The Company recorded total charges of \$6.1 million based on the estimates of the cost of severance benefits for the affected employees and will charge an additional \$0.5 million to restructuring expense in the next two fiscal quarters as certain severance benefits are earned. Additionally, the Company recorded restructuring charges of \$4.0 million relating to the consolidation of certain facilities under non-cancelable leases which were vacated. The facility charges were determined in accordance with the provisions of SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*. As a result, the Company recorded the present value of the future lease obligations, in excess of the expected future sublease income, using a discount rate of approximately 8.0%, and will accrete the approximate \$2.2 million into expense over the remaining life of the leases. The accrual for facility charges includes a \$1.0 million non-cash reclassification of a portion of the deferred

Table of Contents

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

gain on the previous sale of the facility, which has now been partially vacated. Subsequent to December 31, 2004, the Company launched an additional set of headcount reduction actions.

Activity and liability balances recorded as part of the 2005 Restructuring Action through December 31, 2004 were as follows (in thousands):

	Workforce reductions	Facility and other	Total
Charged to costs and expenses	\$ 6,073	\$ 4,006	\$ 10,079
Non-cash items	(22)	979	957
Cash payments	(3,333)		(3,333)
Restructuring balance, December 31, 2004	\$ 2,718	\$ 4,985	\$ 7,703

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

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

Activity and liability balances recorded as part of the 2004 Merger Related Reorganization Plan pertaining to Conexant, Inc. employees and facilities through December 31, 2004 were as follows (in thousands):

Workforce reductions	Facility and other	Total
---------------------------------	-------------------------------	--------------

Edgar Filing: CONEXANT SYSTEMS INC - Form 10-Q

Recorded in purchase price allocation	\$ 1,300	\$ 13,509	\$ 14,809
Adjusted to purchase price allocation	210	(3,554)	(3,344)
Cash payments	(536)	(788)	(1,324)
Restructuring balance, September 30, 2004	974	9,167	10,141
Cash payments	(277)	(273)	(550)
Restructuring balance, December 31, 2004	\$ 697	\$ 8,894	\$ 9,591

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

Table of Contents

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

employees left the Company through December 2004. Additionally, the Company recorded restructuring charges of \$1.9 million relating to the consolidation of certain facilities under non-cancelable leases which were vacated.

During the fourth fiscal quarter of 2004, the Company announced additional workforce reduction actions in response to lower than anticipated revenue levels. The Company has recorded a total of \$9.0 million based on the estimates of the cost of severance benefits for the affected employees and will charge an additional \$0.8 million to restructuring expense in the next two fiscal quarters as certain severance benefits are earned. The Company notified approximately 230 employees of their involuntary termination, including approximately 180 domestic and 50 international employees. These employees will be leaving the Company through June 2005. The workforce reductions affected employees in all areas of the business.

Activity and liability balances recorded as part of the 2004 Merger Related Restructuring Plan pertaining to Conexant Systems, Inc. employees and facilities and the additional fourth fiscal quarter of 2004 restructuring action through December 31, 2004 were as follows (in thousands):

	Workforce reductions	Facility and other	Total
Charged to costs and expenses	\$ 7,066	\$ 1,877	\$ 8,943
Cash payments	(2,368)	(281)	(2,649)
Restructuring balance, September 30, 2004	4,698	1,596	6,294
Charged to costs and expenses	1,892		1,892
Cash payments	(2,034)	(197)	(2,231)
Restructuring balance, December 31, 2004	\$ 4,556	\$ 1,399	\$ 5,955

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

Activity and liability balances related to the 2003 Corporate Restructuring Plan through December 31, 2004 were as follows (in thousands):

	Workforce reductions	Facility and other	Total
Charged to costs and expenses	\$ 1,181	\$ 2,830	\$ 4,011
Cash payments	(364)		(364)
Restructuring balance, September 30, 2003	817	2,830	3,647
Charged to costs and expenses	350	98	448

Expense reversal	(81)		(81)
Cash payments	(1,086)	(933)	(2,019)
Restructuring balance, September 30, 2004		1,995	1,995
Cash payments		(38)	(38)
Restructuring balance, December 31, 2004	\$	\$ 1,957	\$ 1,957

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

As part of the 2002 Corporate and Manufacturing Restructuring Plan, during the first quarter of fiscal 2003, the Company initiated a further workforce reduction affecting 58 employees and recorded additional charges of \$1.9

Table of Contents

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

million based upon estimates of the cost of severance benefits for the affected employees. During the third quarter of fiscal 2003, the Company revised its estimate of liabilities for severance benefits and facility costs due to unfavorable sublease experience to date, and charged an additional \$1.5 million to restructuring. In the fourth quarter of 2003, the Company reversed \$1.1 million of the estimated cost to settle the remaining commitment under a license obligation after its favorable resolution, and increased the estimate of remaining facility costs due to unfavorable sublease experience.

Activity and liability balances related to the 2002 Corporate and Manufacturing Restructuring Plan through December 31, 2004 were as follows (in thousands):

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

Through December 31, 2004, the Company has paid an aggregate of \$43.6 million in connection with all of its restructuring plans and has a remaining accrued restructuring balance of \$28.2 million. The Company expects to pay the amounts accrued for the workforce reductions through fiscal 2005 and expects to pay the obligations for the non-cancelable lease and other commitments over their respective terms, which expire through fiscal 2021. Cash payments to complete the restructuring actions will be funded from available cash reserves and funds from product sales, and are not expected to significantly impact the Company's liquidity.

Integration Charges

During the three months ended December 31, 2004, the Company incurred \$3.5 million of costs related to the integration efforts of the employees, customers, operations and other business aspects related to the Merger.

Other

Other special charges in the first fiscal quarter of 2005 principally consist of \$2.3 million of stock option and warrant modification charges and \$1.0 million of other special charges.

8. Segment Information

SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information, establishes standards for the way that public business enterprises report information about operating segments in annual consolidated financial statements. Although we had four operating segments at December 31, 2004, under the aggregation criteria set forth in SFAS No. 131, we only operate in one reportable operating segment, broadband communications.

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

the nature of products and services;

the nature of the production processes;

Table of Contents

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

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

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

We meet each of the aggregation criteria for the following reasons:

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

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

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

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

Because we meet each of the criteria set forth above and each of our operating segments has similar economic characteristics, we aggregate our results of operations in one reportable operating segment.

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

	Three months ended December 31,	
	2004	2003
Americas	\$ 18,439	\$ 22,401
Asia-Pacific	105,472	140,362
Europe, Middle East and Africa	16,710	14,570
	\$ 140,621	\$ 177,333

The Company believes a portion of the products sold to original equipment manufacturers (OEMs) and third-party manufacturing service providers in the Asia-Pacific region are ultimately shipped to end-markets in the Americas and Europe. For the three months ended December 31, 2004, no customer accounted for 10% of net revenues. For the three months ended December 31, 2003, one customer (a foreign reseller) accounted for 14% of net revenues. No other customer accounted for 10% or more of the Company's net revenues for the three months ended December 31, 2003.

9. Guarantees

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

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

Table of Contents

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

10. Mindspeed Credit Facility

In connection with the spin-off of our Mindspeed Technologies business in June 2003, the Company entered into a senior secured revolving credit facility pursuant to which Mindspeed could have borrowed up to \$50.0 million for working capital and general corporate purposes. On December 2, 2004, the Company and Mindspeed amended the credit facility. On December 8, 2004 Mindspeed completed a \$46.0 million convertible subordinated note offering, thereby terminating the credit facility in accordance with the amended agreement.

11. Stock Option Exchange Program

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

Table of Contents

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

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

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

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

We market and sell our semiconductor products and system solutions directly to leading original equipment manufacturers (OEMs) of communication electronics products, and indirectly through electronic components distributors. We also sell our products to third-party electronic manufacturing service providers, who manufacture products incorporating our semiconductor products for OEMs. Sales to distributors and other resellers accounted for approximately 26% of net revenues in the first fiscal quarter of 2005. No customer accounted for 10% of our net revenues in the first fiscal quarter of 2005. Our top 20 customers accounted for approximately 74% of net revenues for the first fiscal quarter of 2005. Revenues derived from customers located in the Asia-Pacific region, the Americas, and Europe were 75%, 13%, and 12%, respectively, of our net revenues for the first fiscal quarter of 2005. We believe a portion of the products we sell to OEMs and third-party manufacturing service providers in the Asia-Pacific region are ultimately shipped to end-markets in the Americas and Europe.

Overview of Current Performance

Our net revenues for the first fiscal quarter of 2005 and 2004 were \$140.6 million and \$177.3 million, respectively. This represents a decrease of \$36.7 million or 20.7%. Our net revenues for the first fiscal quarter of 2004 do not include the results of the GlobespanVirata business. The decline in net revenues from the first fiscal quarter of 2004 is due to lower revenues in our Universal and Voice Access and Broadband Media Processing businesses caused by reduced demand and lower average selling prices, offset by additional revenues from our Wireless Networking

business as a result of products acquired in the Merger.

Pro forma net revenue (including the results of the GlobespanVirata business from October 1, 2003) for the first fiscal quarter of 2004 was \$314.6 million. Compared to pro forma first fiscal quarter of 2004 net revenues, our first fiscal quarter of 2005 net revenues declined \$173.9 million or 55.3%. Compared to our net revenues for the fourth

Table of Contents

fiscal quarter of 2004, our first fiscal quarter of 2005 net revenues declined \$72.5 million or 34.0% from \$213.1 million.

The use of net revenues for the combined companies as if the Merger had closed at the beginning of the quarter ended December 31, 2003 is a non-GAAP financial measure, which is used by management to provide useful information in establishing a meaningful comparison of revenue levels. It is not intended to be an alternative to GAAP measures.

During fiscal 2004, we experienced lower than expected end customer demand which resulted in excess channel inventory build up at our direct customers, distributors and resellers, price erosion in the Wireless Networking and Broadband Access businesses and market share loss in our Wireless Networking business. During the quarter ended December 31, 2004, we reduced channel inventory at our distributors by approximately \$40.0 million and we believe that there was an approximate \$10.0 million reduction of channel inventory at our direct customers (See Results of Operations - Net Revenues). The reduction in demand, average selling price erosion and channel inventory reduction resulted in the net revenue decline from the quarter ended December 31, 2003 to the quarter ended December 31, 2004. The sequential decline in net revenues from the quarter ended September 30, 2004 to the quarter ended December 31, 2004 is primarily attributable to the reduction in channel inventories as mentioned above and lower net revenues in the Broadband Access business.

The reduced demand outlook for fiscal year 2005 and the further decline of average selling prices in Wireless Networking products resulted in first quarter internal and channel inventory charges aggregating \$52.9 million. These charges include \$26.2 million for excess and obsolete inventory primarily related to Broadband Access and Wireless Networking products, \$18.8 million of lower of cost or market write-downs for Wireless Networking inventory and \$7.9 million of pricing adjustments to inventories in the channel (See Results of Operations- Net Revenues).

Since the completion of the Merger, we have announced several workforce reduction and facilities consolidation actions in order to achieve operational efficiencies. In the fourth quarter of fiscal 2004, we announced additional workforce reductions to implement further Merger synergies and to align our operating expenses to lower revenue forecasts. Certain of these actions have been completed, and others are in the process of being completed. In November 2004, we announced a plan to reduce quarterly operating expenses by an additional \$15.0 million. The primary drivers of the expense reductions are expected to be an increasing shift of product development resources to lower-cost regions and cost savings from continued Merger-related selling, general and administrative consolidation. In December 2004, we completed the acquisition of Paxonet Communications, a semiconductor product development company with an experienced and lower-cost engineering team based in India. In January 2005, we launched an additional set of headcount reduction actions that will bring us closer to our operating expense objectives. See Notes 2 and 7 of Notes to Consolidated Condensed Financial Statements for further information. The cost savings of these actions are expected to be fully reflected in the quarter ending December 31, 2005. We continuously evaluate our business in light of current market and competitive conditions to ensure that our operating expenses are in line with our expected revenue forecasts. As a result, future periods will require further actions to reduce operating expenses. We do not believe that these actions have or will inhibit our ability to invest in appropriate levels of research and development.

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

	Three months ended			Change	Change
	Dec. 31, 2004	Sept. 30, 2004	Dec. 31, 2003	from Sept. 2004 Quarter	from Dec. 2003 Quarter
(in millions)					
Net revenues	\$ 140.6	\$ 213.1	\$ 177.3	(34)%	(21)%

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

We have more than 20 distributor customers for whom revenue is recognized upon our shipment of product to them, as our contractual terms provide for no rights of return. During the first fiscal quarter of 2005, we made a business decision to assist primarily three distribution customers to more rapidly sell their inventory by accepting net product returns of \$13.3 million and making price adjustments of \$7.9 million on certain of their products in inventory. As a result of implementing these returns and adjustments, which are a departure from our contractual terms with these customers, we have decided that it is appropriate to defer the recognition of revenue on sales to these distributors until the purchased products are sold by the distributors to a third party. We do not believe that this method of revenue recognition, for these three customers, will have a material impact on our net revenues in future quarters.

See Overview of Current Performance above for a discussion of net revenues.

Gross Margin

	Three months ended			Change	Change
	Dec. 31, 2004	Sept. 30, 2004	Dec. 31, 2003	from Sept. 2004 Quarter	from Dec. 2003 Quarter
(in millions)					
Gross margin	\$ 7.2	\$ 85.4	\$ 79.1	(92)%	(91)%
Percent of net revenues	5%	40%	45%		

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

Our gross margin for the first fiscal quarter of 2005 was 5% compared with the similar period of fiscal 2004 gross margin of 45% and the immediately preceding quarter of 40%. The gross margin percentage decrease from the first fiscal quarter of 2004 is attributable to the effects of the \$52.9 million of internal and channel inventory charges recorded in the first fiscal quarter of 2005, of which \$45.0 million was recorded against cost of goods sold and \$7.9 million against net revenues, and lower average selling prices on many of our products. Excluding the above mentioned charges of \$52.9 million in the first fiscal quarter of 2005, our gross margin would have remained at 40%, consistent with the fourth fiscal quarter of 2004.

We assess the recoverability of our inventories at least quarterly through a review of inventory levels in relation to foreseeable demand, generally over nine to twelve months. Foreseeable demand is based upon all available information, including sales backlog and forecasts, product marketing plans and product life cycle information. When the inventory on hand exceeds the foreseeable demand, we write down the value of those inventories which,

Table of Contents

at the time of our review, we expect to be unable to sell. The amount of the inventory write-down is the excess of historical cost over estimated realizable value. Once established, these write-downs are considered permanent adjustments to the cost basis of the excess inventory. Demand for our products may fluctuate significantly over time, and actual demand and market conditions may be more or less favorable than those projected by management. In the event that actual demand is lower than originally projected, additional inventory write-downs may be required. Similarly, in the event that actual demand exceeds original projections, gross margins may be favorably impacted in future periods. During the quarter ended December 31, 2004, we recorded \$26.2 million in inventory charges for excess and obsolete inventory.

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

Further, on a quarterly basis, we assess the net realizable value of our inventories. When the estimated average selling price, plus costs to sell our inventory falls below our inventory cost, we adjust our inventory to its current estimated market value. During the quarter ended December 31, 2004, we recorded \$18.8 million in inventory charges to adjust certain Wireless Networking products to their estimated market value. Increases or decreases to this inventory reserve may be required based upon actual average selling prices and changes to our current estimates. These reserve adjustments may impact our gross margin percentage in future periods.

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

Research and Development

	Three months ended			Change	Change
	Dec. 31, 2004	Sept. 30, 2004	Dec. 31, 2003	from Sept. 2004 Quarter	from Dec. 2003 Quarter
(in millions)					
Research and development	\$ 72.5	\$ 72.8	\$ 39.2	nm	85%
Percent of net revenues	52%	34%	22%		

nm = not meaningful

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

advanced package development, and non-cash stock compensation charges related to the amortization of unvested stock options exchanged in the Merger.

The \$33.3 million increase in R&D expenses for the first quarter of fiscal 2005 compared to the similar period of fiscal 2004 primarily reflects additional development costs associated with DSL and Wireless Networking products as a result of the Merger, an increase of \$2.2 million in stock compensation charges as a result of the Merger, and to a much lesser extent, increased R&D project costs associated with increases in labor, purchased R&D and electronic design automation tools. As a result of cost reduction initiatives, we expect that R&D expenses will be lower in future periods.

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

(in millions)	Three months ended			Change from	Change from
	Dec. 31, 2004	Sept. 30, 2004	Dec. 31, 2003	Sept. 2004 Quarter	Dec. 2003 Quarter
Selling, general and administrative	\$ 30.0	\$ 35.7	\$ 22.8	(16)%	32%
Percent of net revenues	21%	17%	13%		

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

The \$7.2 million increase in SG&A expense for the three months ended December 31, 2004 compared to the same period of fiscal 2004 is attributable to additional SG&A costs as a result of the Merger and a \$0.7 million increase in stock compensation charges as a result of the Merger.

When compared to the immediately preceding quarter, SG&A expense decreased \$5.7 million to \$30.0 million from \$35.7 million. This decrease is primarily a result of accounts receivable bad debt charges taken in the fourth fiscal quarter of 2004 and to a lesser extent the impact of our cost reduction initiatives. As a result of cost reduction initiatives, we expect that SG&A expenses will be lower in future periods.

Amortization of Intangible Assets

(in millions)	Three months ended December 31,		
	2004	Change	2003
Amortization of intangible assets	\$ 8.3	nm	\$ 1.0
Percent of net revenues	nm		nm

nm = not meaningful

Amortization expense is recorded for intangible assets other than goodwill pursuant to SFAS Nos. 141 and 142. SFAS No. 141 requires that all business combinations be accounted for using the purchase method and provides criteria for recording intangible assets separately from goodwill. Goodwill must be tested at least annually for impairment and written down when impaired.

The increased amortization expense in the three months ended December 31, 2004 compared to the three months ended December 31, 2003 is primarily attributable to the significant intangible assets we acquired in the Merger. See Note 2 of Notes to Consolidated Condensed Financial Statements for further information. We expect that amortization of intangible assets will be approximately \$23.7 million for the remainder of fiscal 2005.

Special Charges

Special charges consist of the following:

(in millions)	Three months ended December		
	2004	31, Change	2003
Restructuring charges	\$ 12.0	nm	\$ 0.4
Asset impairment charges	0.5	nm	0.2
Integration charges	3.5	nm	
Other	3.3	nm	
	\$ 19.3		\$ 0.6

nm= not meaningful

Table of Contents

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

Other (Income) Expense, Net

(in millions)	Three months ended December 31,		
	2004	Change	2003
Other (income) expense, net	\$ (2.8)	nm	\$ (25.3)
Percent of net revenues	nm		nm

nm= not meaningful

Other (income) expense, net for the first fiscal quarter of 2005 was comprised of a \$14.8 million increase in the fair value of the Mindspeed warrant, \$0.6 million of investment and interest income on invested cash balances, offset by \$8.4 million of interest expense primarily from our convertible subordinated notes, \$3.1 million of loss in our equity method investments and foreign exchange transaction losses. Due to variations in the fair value of the common stock underlying the Mindspeed warrant, we expect that other (income) expense, net may fluctuate significantly in future periods until this derivative instrument is liquidated.

Other (income) expense, net for the first quarter of fiscal 2004 was comprised of a \$24.6 million increase in the fair value of the Mindspeed warrant, \$10.2 million of income in our equity method investments (including a \$11.4 million gain in accordance with Staff Accounting Bulletin No. 51 for the realization of an additional investment made by another party in Jazz) and \$2.5 million of investment and interest income on invested cash balances, offset by \$6.7 million of interest expense on our convertible subordinated notes and a \$4.9 million decrease in the fair value of the conversion right under the Skyworks 15% convertible senior subordinated notes. The \$11.4 million gain in our investment in Jazz is the result of our ownership in Jazz decreasing from 45% to approximately 38% when the additional favorable investment was realized.

As a result of the acquisition of \$130.0 million of the 5.25% convertible subordinated notes in the Merger, interest expense in the three months ended December 31, 2004 was higher than in the three months ended December 31, 2003.

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

Provision for Income Taxes

We recorded income tax expense of \$0.5 million and \$0.2 million for the three months ended December 31, 2004 and 2003, respectively, primarily reflecting taxes imposed on our foreign subsidiaries. No federal income tax expense was recorded for the first fiscal quarter of 2005 due to our net loss in the quarter and no federal income tax was recorded in the first fiscal quarter of 2004 as the net income for that period was offset by net operating loss carryovers that have a full valuation allowance recorded against them. Except to the extent of the federal alternative minimum tax, we expect this will continue for the foreseeable future. We do not expect to recognize any income tax benefits relating to future operating losses until we believe that such tax benefits are more likely than not to be realized.

As of December 31, 2004, Conexant had \$1.1 billion of fully reserved deferred tax assets which are available to offset future tax obligations subject to limitations imposed by section 382 of the Internal Revenue Code.

Table of Contents**Liquidity and Capital Resources**

Our cash and cash equivalents decreased by \$6.7 million during the first fiscal quarter of 2005. Cash used by operating activities was \$16.1 million for the first fiscal quarter of 2005, compared to cash provided by operating activities of \$22.6 million for the comparable period in fiscal 2004. Operating cash flows for the first fiscal quarter of 2005 were approximately \$4.0 million, excluding an \$8.0 million payment to Agere for the settlement of patent litigation, and \$12.0 million of payments related to special charges and other items. The \$4.0 million was primarily a result of approximately \$55.2 million of favorable changes in accounts receivable, inventories, accounts payable, accrued expenses and other current liabilities and other during the first fiscal quarter of 2005.

Cash provided by investing activities of \$8.8 million for the first fiscal quarter of 2005 includes net sales of marketable securities of \$27.1 million, partially offset by net cash paid for an acquisition of \$14.5 million, capital expenditures of \$2.1 million, and investments of \$1.8 million. Cash used in investing activities of \$15.1 million in the first three months of fiscal 2004 principally consisted of \$4.3 million of net purchases of marketable securities, capital expenditures of \$4.9 million, payment of deferred purchase consideration of \$4.0 million, and deferred merger costs of \$1.4 million.

Cash provided by financing activities of \$0.6 million for the first fiscal quarter of 2005 consisted of \$0.4 million in proceeds from the exercise of stock options and \$0.2 million from repayment of an employee loan. The \$6.1 million in cash provided by financing activities for the comparable period of fiscal 2004 consisted of proceeds from the exercise of stock options.

As of December 31, 2004, our principal sources of liquidity are our existing cash reserves and marketable securities, the current portion of the Mindspeed warrant, our investments in third parties, such as Jazz, and cash generated from product sales. Our working capital at December 31, 2004 was \$307.0 million compared to \$434.8 million at September 30, 2004. In addition, at December 31, 2004, we held \$123.3 million in long-term marketable securities which we could liquidate to fund operations and/or future acquisitions.

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

(in millions)	December 31, 2004	September 30, 2004
Cash and cash equivalents	\$ 132.3	\$ 139.0
Other short-term marketable securities (primarily mutual funds, domestic government agencies and corporate debt securities)	2.6	13.8
Long-term marketable securities (primarily domestic government agencies and corporate debt securities)	123.3	137.6
Subtotal	258.2	290.4
Equity securities- Skyworks Solutions, Inc. (6.2 million shares at December 31, 2004 and September 30, 2004)	58.3	61.8
Equity securities- SiRF Technologies, Inc. (5.9 million shares at December 31, 2004 and September 30, 2004)	74.7	87.5
Subtotal Skyworks and SiRF	133.0	149.3

Total cash, cash equivalents and marketable securities	\$	391.2	\$	439.7
--	----	-------	----	-------

The current portion of the Mindspeed warrant at December 31, 2004 is \$5.6 million, and the long-term portion is \$35.7 million. The valuation of this derivative instrument is subjective, and at any point in time could ultimately result in the realization of amounts significantly different than the carrying value. Further, there is no assurance that the equity markets would allow for the Company to liquidate a substantial portion of these warrants within a short time period without significantly impacting the market value. We believe that our existing sources of liquidity will be sufficient to fund our operations, research and development efforts, anticipated capital expenditures, and other liabilities and commitments, and other capital requirements, for at least the next twelve months. We will need to continue a focused program of capital expenditures to meet our research and development and corporate requirements. We may also consider acquisition opportunities to extend our technology portfolio and design expertise and to expand our product offerings. In order to fund capital expenditures, increase our working capital or complete any acquisitions, we may seek to obtain additional debt financing or issue additional shares of our

Table of Contents

common stock. However, we cannot assure you that such financing will be available to us on favorable terms, or at all.

We have \$711.8 million aggregate principal amount of convertible subordinated notes outstanding of which approximately \$200.0 million become due in fiscal 2006 and the remainder becomes due in fiscal 2007. The conversion prices of the notes are currently in excess of the market value of our common stock. As of December 31, 2004, we had \$391.2 million of cash and investments. If we are unable to generate sufficient cash flows from our operations or realize additional value from our investments and other assets, we may have to seek additional sources of financing. We cannot assure you that such financing will be available to us on favorable terms, or at all.

The following summarizes our contractual obligations at December 31, 2004:

(in millions)	Total	Payments due by period			More than 5 years
		Less than 1 Year	1-3 years	3-5 years	
Convertible subordinated notes (1)	\$ 711.8	\$	\$ 711.8	\$	\$
Operating leases	143.2	27.0	35.9	20.5	59.8
Assigned leases	14.6	5.3	4.5		4.8
Contingent consideration on acquisitions	4.0		4.0		
Capital commitments	4.4	4.4			
Purchase commitments	14.2	14.2			
Assigned purchase commitments	6.0	6.0			
Employee commitments	4.6	4.6			
	\$ 902.8	\$ 61.5	\$ 756.2	\$ 20.5	\$ 64.6

(1) Excludes interest. See Note 3 of Notes to Consolidated Condensed Financial Statements for interest terms. In addition to the contractual obligations listed above, we have exercised our purchase option for approximately \$60.0 million to purchase two buildings in Newport Beach, California which are currently occupied under a lease agreement. Pursuant to the terms of the currently proposed sale-leaseback transaction with respect to these facilities, which is expected to be executed in the quarter ending March 31, 2005, the proceeds from the sale-leaseback transaction will substantially exceed the purchase price of \$60.0 million.

At December 31, 2004, the Company has many sublease arrangements on operating leases for terms ranging from near term to approximately 6 years. Aggregate scheduled sublease income based on current terms is approximately \$7.5 million.

Off-Balance Sheet Arrangements

Our off-balance arrangements consist of conventional operating leases, capital commitments, employee commitments, and purchase commitments as described in Note 5 of Notes to Consolidated Condensed Financial Statements. We also have contingent liabilities for other items assigned to Mindspeed and Skyworks at the time of their separation from Conexant. See Note 5 of Notes to Consolidated Condensed Financial Statements. We do not have any special purpose entities or variable interest entities as of December 31, 2004.

In connection with the Mindspeed Spin, we entered into a senior secured revolving credit facility pursuant to which Mindspeed could have borrowed up to \$50.0 million for working capital and general corporate purposes. On December 2, 2004, we and Mindspeed amended the credit facility. On December 8, 2004 Mindspeed completed a \$46.0 million convertible subordinated note offering, thereby terminating the credit facility in accordance with the amended agreement.

Table of Contents**Critical Accounting Policies**

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

Business combinations

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

Impairment of long-lived assets

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

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

Deferred income taxes

We evaluate the realizability of our deferred tax assets and assess the need for a valuation allowance quarterly. We record a valuation allowance to reduce our deferred tax assets to the net amount that is more likely than not to be realized. Our assessment of the need for a valuation allowance is based upon our history of operating results,

expectations of future taxable income and the ongoing prudent and feasible tax planning strategies available to us. In the event that we determine that we will not be able to realize all or part of our deferred tax assets in the future, an adjustment to the deferred tax assets would be charged against income in the period such determination is made. Likewise, in the event we were to determine that we will be able to realize our deferred tax assets in the future in excess of the net recorded amount, an adjustment to the deferred tax assets would increase income in the period such

Table of Contents

determination is made. To the extent that we realize a benefit from reducing the valuation allowance on acquired deferred tax assets, the benefit will be credited to goodwill.

Inventories

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

Allowance for doubtful accounts

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

Non-marketable equity securities

We have a portfolio of strategic investments in non-marketable equity securities. Our ability to recover our investments in private, non-marketable equity securities and to earn a return on these investments is primarily dependent on how successfully these companies are able to execute to their business plans and how well their products are accepted, as well as their ability to obtain venture capital funding to continue operations and to grow. We review all of our investments periodically for impairment and an impairment analysis of non-marketable equity securities requires significant judgment. This analysis includes assessment of each investee's financial condition, the business outlook for its products and technology, its projected results and cash flows, the likelihood of obtaining subsequent rounds of financing and the impact of any relevant contractual equity preferences held by us or by others. Overall business valuations have declined significantly over the past two years, and as a result we have experienced substantial impairments in the value of non-marketable equity securities investments we hold. Future adverse changes in market conditions or poor operating results of underlying investments could result in an inability to recover the carrying value of our investments that may not be reflected in their current carrying values, which could require additional impairment charges to write down the carrying values of such investments.

Revenue Recognition

Revenue from product sales is recognized upon shipment to the customer, when the risk of loss has been transferred to the customer, price and terms are fixed, no significant vendor obligation exists and collection of the resulting receivable is reasonably assured. Revenue recognition is deferred in all instances where the earnings process is incomplete. Certain product sales are made to electronic component distributors under agreements allowing for a right to return unsold products. Recognition of revenue on all sales to these distributors is deferred until the products are

sold by the distributors to a third party. A reserve for sales returns and allowances for other customers is recorded based on historical experience or specific identification of an event necessitating a reserve. Our revenue recognition policy is significant because our revenue is a key component of our operations and the timing of revenue recognition determines the timing of certain expenses, such as sales commissions. Revenue results are difficult to predict, and any shortfall in revenues could cause our operating results to vary significantly from period to period.

Conexant has more than 20 distributor customers for whom revenue is recognized upon its shipment of product to them, as the contractual terms provide for no rights of return. During the first fiscal quarter of 2005, the Company made a business decision to assist primarily three distribution customers to more rapidly sell their inventory by

Table of Contents

accepting net product returns of \$13.3 million and making price adjustments of \$7.9 million on certain of their products in inventory. As a result of implementing these returns and adjustments, which are a departure from our contractual terms with these customers, we have decided that it is appropriate to defer the recognition of revenue on sales to these three distributors until the purchased products are sold by the distributors to a third party.

Valuation of derivative instruments

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

Restructuring charges

We recorded \$12.0 million of restructuring charges in the quarter ended December 31, 2004. These charges relate to reductions in our workforce and related impact on the use of facilities. The estimated charges contain estimates and assumptions made by management about matters which are uncertain at the time, for example the timing and amount of sublease income that will be achieved on vacated property and the operating costs to be paid until lease termination, and the discount rates used in determining the present value (fair value) of remaining minimum lease payments on vacated properties. While we have used our best estimates based on facts and circumstances available at the time, different estimates reasonably could have been used in the relevant periods, and the actual results may be different, and those differences could have a material impact on the presentation of our financial condition or results of operations. Our policies require us to review the estimates and assumptions periodically and reflect the effects of any revisions in the period that they are determined to be necessary. In addition, as a result of the Merger in February 2004, we acquired \$11.5 million (as adjusted) of additional restructuring liabilities which were recorded through the purchase price allocation. Such amounts also contain estimates and assumptions made by management, and are reviewed periodically and adjusted accordingly.

Employee benefit plans

We have long-term liabilities recorded for a retirement medical plan and a pension plan. These obligations and the related effects on operations are determined using actuarial valuations. There are critical assumptions used in these valuation models such as the discount rate, expected return on assets, compensation levels, turnover rates and mortality rates. The discount rate used is representative of a high-quality fixed income investment. The other assumptions do not tend to change materially over time. We evaluate all assumptions annually and they are updated to reflect our experience.

Stock-based compensation

We account for employee stock-based compensation in accordance with the provisions of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB 25) and therefore no compensation expense has been recognized for fixed stock option plans as options are granted at fair market value on the date of grant. We also have an employee stock purchase plan for all eligible employees. We have adopted the pro forma disclosure

provisions of Statement of Financial Accounting Standards (SFAS) No. 123, Accounting for Stock-Based Compensation, as amended by SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure. In December 2004, the Financial Accounting Standards Board issued SFAS No. 123 (R), Share-Based Payment . This pronouncement amends SFAS No. 123 and supersedes APB Opinion No. 25. SFAS No 123 (R) requires that public companies account for awards of equity instruments issued to employees under the fair value method of accounting and recognize such amounts in the statement of operations. This statement is effective beginning with our fourth fiscal 2005 quarter beginning July 2, 2005. We expect the impact of this new pronouncement to be significant to our results of operations.

Table of Contents

Certain Business Risks

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

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

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

Each of Conexant, GlobespanVirata and the combined company has recently incurred substantial losses and we anticipate additional future losses.

Our net revenues for the first quarter of fiscal 2005 and for fiscal 2004 were \$140.6 million and \$901.9 million, respectively. Our net loss for the first quarter of fiscal 2005 and for fiscal 2004 was \$120.7 million and \$544.6 million, respectively.

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

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

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

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

revenues and results of operations and those of Conexant and GlobespanVirata. Conexant and

Table of Contents

GlobespanVirata experienced these cyclical fluctuations in their businesses in the past and we have experienced, and may in the future experience, cyclical fluctuations.

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

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

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

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

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

seasonal customer demand;

the gain or loss of significant customers;

market acceptance of our products and our customers' products;

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

the timing and extent of product development costs;

new product and technology introductions by competitors;

changes in the mix of products we develop and sell;

fluctuations in manufacturing yields;

availability and cost of products from our suppliers;

intellectual property disputes; and

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

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

Our net revenues for the first fiscal quarter of 2005 and 2004 were \$140.6 million and \$177.3 million, respectively. This represents a decrease of \$36.7 million or 20.7%. Our net revenues for the first fiscal quarter ended December 31, 2003 do not include the results of the GlobespanVirata business. Our pro forma net revenue (as if the Merger had been completed on October 1, 2003) for the first fiscal quarter ended December 31, 2003 was \$314.6 million. Compared to pro forma net revenues for the first fiscal quarter of 2004, our first fiscal quarter of 2005 net revenues declined \$173.9 million or 55.3%. Compared to our net revenues for the fourth fiscal quarter of 2004, our first fiscal quarter of 2005 revenues have declined \$72.5 million or 34.0% from \$213.1 million.

The use of net revenues for the combined companies as if the Merger had closed at the beginning of the quarter ended December 31, 2003 is a non-GAAP financial measure, which is used by management to provide useful information in establishing a meaningful comparison of revenue levels. It is not intended to be an alternative to GAAP measures.

During fiscal 2004, we experienced lower than expected customer demand, price erosion in the Wireless Networking and Broadband Access businesses and market share loss in our Wireless Networking business. During the December quarter of 2004, we reduced channel inventory at our distributors by approximately \$40.0 million and we believe that there was an additional \$10.0 million of channel inventory reduction at our direct customers. The reduction in demand, average selling price erosion in the Wireless Networking product line, and channel inventory reduction led to the year over year net revenue decline. The sequential decline in revenue is primarily attributable to the reduction in channel inventory and to lower net revenues in the Broadband Access business.

We cannot assure you whether or when these factors will improve and our business, financial condition and results of operations may continue to be adversely impacted by these factors.

Table of Contents

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

We believe that our existing sources of liquidity together with cash expected to be generated from product sales will be sufficient to fund our operations, research and development, anticipated capital expenditures, working capital and other financing requirements for at least the next twelve months. However, we cannot assure you that this will be the case and we may need to obtain alternate sources of financing in the future. At December 31, 2004, we have \$711.8 million aggregate principal amount of convertible subordinated notes outstanding which become due in several tranches beginning in May 2006 and ending in February 2007. The conversion prices of the notes are currently in excess of the market value of our common stock. If we are unable to generate sufficient cash flows from our operations or realize additional value from our investments and other assets, we may be unable to meet our debt obligations as they become due. We cannot assure you that we will have access to additional sources of capital, or be able to refinance our debt, on favorable terms or at all. In periods of a depressed stock price, raising capital through the equity markets would have a greater effect on shareholder dilution.

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

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

We are subject to intense competition.

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

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

time-to-market;

product quality, reliability and performance;

level of integration;

price and total system cost;

compliance with industry standards;

design and engineering capabilities;

strategic relationships with customers;

customer support;

new product innovation; and

access to manufacturing capacity.

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

Current and potential competitors also have established or may establish financial or strategic relationships among themselves or with our existing or potential customers, resellers or other third parties. These relationships may affect customers' purchasing decisions. Accordingly, it is possible that new competitors or alliances could emerge and

Table of Contents

rapidly acquire significant market share. We cannot assure you that we will be able to compete successfully against current and potential competitors.

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

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

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

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

the necessity of coordinating geographically separate organizations;

retaining and integrating personnel with diverse business backgrounds;

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

retaining existing customers and strategic partners of each company; and

implementing and maintaining consistent standards, controls, procedures, policies and information systems.

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

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

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

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

issuances of equity securities dilutive to our existing shareholders;

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

the incurrence of substantial debt and assumption of unknown liabilities;

the potential loss of key employees from the acquired company;

amortization expenses related to intangible assets; and

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

Additionally, in periods subsequent to an acquisition, at least on an annual basis, we must evaluate goodwill and acquisition-related intangible assets for impairment. When such assets are found to be impaired, they will be written down to estimated fair value, with a charge against earnings. At December 31, 2004, we have \$714.9 million of goodwill, of which \$627.0 million was generated in the Merger. Our market capitalization was above our book value at December 31, 2004, but our market capitalization was below our book value at September 30, 2004. When market capitalization is below book value, it is an indicator that goodwill may be impaired. We performed an evaluation of our goodwill at December 31, 2004 and determined that as of that date, no impairment was required. However, if our market capitalization drops below our book value for a prolonged period of time, we may be required to write down the value of our goodwill by taking a non-cash charge against earnings.

Table of Contents

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

The trading price of our common stock fluctuates significantly and may be influenced by many factors, including:

- our operating and financial performance and prospects;
- the depth and liquidity of the market for our common stock;
- investor perception of us and the industry and markets in which we operate;
- our inclusion in, or removal from, any equity market indices;
- the level of research coverage of our common stock;
- changes in earnings estimates or buy/sell recommendations by analysts; and

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

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

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

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

- our ability to anticipate customer and market requirements and changes in technology and industry standards;
- our ability to accurately define new products;
- our ability to timely complete development of new products and bring our products to market on a timely basis;
- our ability to differentiate our products from offerings of our competitors;
- overall market acceptance of our products;
- our ability to invest in significant amounts of research and development; and

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

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

technological changes. We also cannot assure you that we will be able to respond successfully to new product announcements and introductions by competitors.

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

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

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

Table of Contents

rapid technological developments;

rapid changes in customer requirements;

frequent new product introductions and enhancements;

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

evolving industry standards.

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

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

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

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

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

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

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

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

Table of Contents

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

Our sales are typically made pursuant to individual purchase orders and we generally do not have long-term supply arrangements with our customers. Generally, our customers may cancel orders until 30 days prior to shipment. In addition, we sell a portion of our products through distributors and other resellers, some of whom have a right to return unsold products to us. Sales to distributors and other resellers accounted for approximately 26% and 36% of our net revenues for the first quarter of fiscal 2005 and for fiscal 2004, respectively. We routinely purchase inventory based on estimates of end-market demand for our customers' products, which is difficult to predict. This difficulty may be compounded when we sell to OEMs indirectly through distributors and other resellers or contract manufacturers, or both, as our forecasts of demand are then based on estimates provided by multiple parties. In addition, our customers may change their inventory practices on short notice for any reason. The cancellation or deferral of product orders, the return of previously sold products or overproduction due to the failure of anticipated orders to materialize could result in our holding excess or obsolete inventory, which could result in write-downs of inventory. For example, the reduced demand outlook for fiscal year 2005 and the further decline of average selling prices for Wireless Networking products resulted in first quarter fiscal 2005 inventory charges and revenue adjustments aggregating \$52.9 million. Inventory charges include \$26.2 million for excess and obsolete inventory primarily related to broadband access and wireless networking products and \$18.8 million of lower of cost or market write-downs for Wireless Networking inventory. Revenue adjustments of \$7.9 million were made to certain channel inventories at certain of our customers.

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

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

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

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

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

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

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

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

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

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

Table of Contents

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

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

We are subject to the risks of doing business internationally.

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

currency exchange rate fluctuations;

local economic and political conditions;

disruptions of capital and trading markets;

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

changes in legal or regulatory requirements;

difficulty in obtaining distribution and support;

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

tax laws; and

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

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

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

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

The semiconductor industry is characterized by vigorous protection and pursuit of intellectual property rights. From time to time, third parties have asserted and may in the future assert patent, copyright, trademark and other

Table of Contents

intellectual property rights to technologies that are important to our business and have demanded and may in the future demand that we license their patents and technology. Any litigation to determine the validity of claims that our products infringe or may infringe these rights, including claims arising through our contractual indemnification of our customers, regardless of their merit or resolution, could be costly and divert the efforts and attention of our management and technical personnel. We cannot assure you that we would prevail in litigation given the complex technical issues and inherent uncertainties in intellectual property litigation. If litigation results in an adverse ruling we could be required to:

pay substantial damages;

cease the manufacture, use or sale of infringing products;

discontinue the use of infringing technology;

expend significant resources to develop non-infringing technology; or

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

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

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

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

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

any of the measures described above would provide meaningful protection.

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

Uncertainties involving litigation could adversely affect our business.

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

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

Conexant's former manufacturing operations used a variety of chemicals and were subject to a wide range of environmental protection regulations in the United States and Mexico. We have been designated as a potentially responsible party and are engaged in groundwater remediation at one Superfund site located at a former silicon wafer manufacturing facility and steel fabrication plant in Parker Ford, Pennsylvania formerly occupied by Conexant. In addition, we are engaged in remediations of groundwater contamination at Conexant's former Newport

Table of Contents

Beach, California wafer fabrication facility. We currently estimate the remaining costs for these remediations to be approximately \$3.0 million and have accrued for these costs as of December 31, 2004.

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

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

As of December 31, 2004, Conexant had approximately \$1.6 billion of U.S. federal income tax net operating loss (NOL) carry forwards that can be used to offset taxable income in subsequent years. The NOL carry forwards are scheduled to expire at various dates through 2023. Section 382 of the Internal Revenue Code could limit the future use of some or all of the NOL carry forwards if the ownership of our common stock changes by more than 50 percentage points in certain circumstances over a three-year testing period. Based on information known to us, we have not undergone such a change of ownership and the merger of Conexant and GlobespanVirata did not constitute a change of ownership, although the shares of our common stock issued in the Merger will be taken into account in any change of ownership computations. Direct or indirect transfers of our common stock, when taken together with the shift in ownership resulting from the Merger, could result in a change of ownership that would trigger the section 382 limitation. If such an ownership change occurs, section 382 would limit our use of NOL carry forwards in each subsequent taxable year to an amount equal to a federal long-term tax-exempt rate published by the Internal Revenue Service at the time of the ownership change, multiplied by our fair market value at such time; any unused annual limitation amounts may also be carried forward. The Merger resulted in a change of ownership of GlobespanVirata and the future use of GlobespanVirata's NOL carry forwards are subject to the section 382 limitation (or further limitation in the case of NOL carry forwards already subject to limitation as a result of previous transactions) based on the fair market value of GlobespanVirata at the time of the Merger.

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

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

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

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

a prohibition on shareholder action by written consent;

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

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

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

a fair price provision.

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

In addition to the rights agreement and the provisions in our restated certificate of incorporation and by-laws, Section 203 of the Delaware General Corporation Law generally provides that a corporation shall not engage in any business combination with any interested shareholder during the three-year period following the time that such

Table of Contents

shareholder becomes an interested shareholder, unless a majority of the directors then in office approves either the business combination or the transaction that results in the shareholder becoming an interested shareholder or specified shareholder approval requirements are met.

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

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

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

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

Our cash and cash equivalents, and short-term marketable securities are not subject to significant interest rate risk due to the short maturities of these instruments. As of December 31, 2004, the carrying value of our cash and cash equivalents and short-term marketable securities approximates fair value. Our long-term marketable securities (consisting of commercial paper, corporate bonds and government securities) principally have remaining terms of 1 to 3 years. Such securities are subject to interest rate risk. At December 31, 2004, a 10% adverse change in interest rates would result in a \$12.3 million decrease in the value of our long-term marketable securities.

Marketable equity securities are subject to equity price risk. For most of our equity security holdings, there are risks associated with the overall state of the stock market, having available buyers for shares we sell, and ultimately being able to liquidate the securities at a favorable price. As of December 31, 2004, a 10% adverse change in equity prices would result in a \$13.4 million decrease in the value of our marketable equity securities.

We classify all of our marketable debt and equity securities as available-for-sale securities. As of December 31, 2004, the carrying value of these securities included net unrealized gain of \$77.0 million.

We hold a warrant to purchase 30 million shares of common stock of Mindspeed. For financial accounting purposes, this is a derivative instrument and the fair value of the warrant is subject to significant risk related to changes in the market price of Mindspeed's common stock. As of December 31, 2004, a 10% decrease in the market price of Mindspeed's common stock would decrease the fair value of this warrant by approximately \$5.7 million. At December 31, 2004, the market price of Mindspeed's common stock was \$2.78 per share. For the

Table of Contents

quarter ended December 31, 2004, the market price of Mindspeed's common stock ranged from a low of \$1.81 per share to a high of \$2.98 per share.

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

The following table shows the fair values of our financial instruments as of December 31, 2004:

(in millions)	Carrying Value	Fair Value
Cash and cash equivalents	\$ 132.3	\$ 132.3
Marketable debt securities	36.4	36.4
Marketable government agency securities	88.3	88.3
Marketable equity securities	134.2	134.2
Mindspeed warrant	41.4	41.4
Long-term debt	711.8	660.0

We transact business in various foreign currencies, and we have established a foreign currency hedging program utilizing foreign currency forward exchange contracts to hedge certain foreign currency transaction exposures. Under this program, from time to time, we offset foreign currency transaction gains and losses with gains and losses on the forward contracts, so as to mitigate our overall risk of foreign transaction gains and losses. We do not enter into forward contracts for speculative or trading purposes. At December 31, 2004, we held no foreign currency forward exchange contracts. Based on our overall currency rate exposure at December 31, 2004, a 10% change in the currency rates would not have a material effect on our consolidated financial position, results of operations or cash flows.

ITEM 4. CONTROLS AND PROCEDURES

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

In connection with the audit of the Company's consolidated financial statements for the fiscal year ended September 30, 2004, certain deficiencies in the Company's internal control over financial reporting were identified, including with respect to the reconciliation of certain accounts payable accounts. These deficiencies arose in connection with the transfer of responsibility for certain accounting functions from Conexant's Newport Beach, California offices to the Company's Red Bank, New Jersey offices as part of the post-merger integration process following the merger of Conexant and GlobespanVirata in February 2004. The Company and its independent auditors did not consider these deficiencies to be a material weakness under applicable auditing standards and they had no material effect on the Company's financial statements. In the quarter ended December 31, 2004, the Company implemented actions to remedy the deficiencies and enhance the Company's internal controls. These actions are expected to be complete in the quarter ending March 31, 2005.

Except as described above, there were no changes in the Company's internal control over financial reporting during the quarter ended December 31, 2004 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

Table of Contents

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

Class Action Suits. In December 2004 and January 2005, the Company and certain current and former officers were named as defendants in several complaints filed on behalf of all persons who purchased Company common stock during a specified class period in the U.S. District Court of New Jersey and the U.S. District Court for the Central District of California, alleging that the defendants violated the Securities Exchange Act of 1934 (the Exchange Act) by allegedly disseminating materially false and misleading statements and/or concealing material adverse facts. The defendants believe these charges are without merit and intend to vigorously defend the litigation.

Shareholder Derivative Suits. In January 2005, the Company and certain current and former directors and officers were named as defendants in purported shareholder derivative actions in California State Court for the County of Orange, alleging that the defendants breached their fiduciary duties, abused control, mismanaged the company, wasted corporate assets and unjustly enriched themselves. The defendants believe these charges are without merit and intend to vigorously defend the litigation.

Agere Systems, Inc. On November 4, 2004, the Company reached a settlement with Agere Systems Inc. (Agere), which among other things, dismissed with prejudice all litigation matters between the two companies. The settlement agreement also provided for the dismissal with prejudice of all claims brought by and against Intersil. Conexant, Inc. (formerly GlobespanVirata, Inc.) acquired the WLAN Group of Intersil in August 2003. As part of this overall litigation settlement, the Company made a cash payment to Agere in the amount of \$8.0 million in November 2004 and the two companies entered into various license agreements covering the patents involved in the suits and other semiconductor devices.

ITEM 6. EXHIBITS

Exhibits:

- 10.1 Amendment dated November 12, 2004 between the Company and F. Matthew Rhodes to Employment Agreement dated as of January 15, 2004 between the Company and Mr. Rhodes filed as Exhibit 10 to the Company's Current Report on Form 8-K dated November 9, 2004 (File No. 000-24923), is incorporated herein by reference.
- 10.2 Retention and Separation Agreement by and between the Company and C. Michael Powell filed as Exhibit 10.1 to the Company's Current Report on Form 8-K dated December 13, 2004 (File No. 000-24923), is incorporated herein by reference.
- 10.3 Separation Agreement by and between the Company and Armando Geday filed as Exhibit 10.1 to the Company's Current Report on Form 8-K dated December 16, 2004 (File No. 000-24923), is incorporated herein by reference.
- 31.1 Certification of the Chief Executive Officer of Periodic Report Pursuant to Rule 13a-15(e) or 15d-15(e).
- 31.2 Certification of the Chief Financial Officer of Periodic Report Pursuant to Rule 13a-15(e) or 15d-15(e).

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

99 Summary of Non-Employee Director Compensation and Benefits

Table of Contents

SIGNATURE

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

CONEXANT SYSTEMS, INC.
(Registrant)

Date: February 8, 2005

By /s/ J. Scott Blouin

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

Table of Contents

EXHIBIT INDEX

31.1	Certification of the Chief Executive Officer of Periodic Report Pursuant to Rule 13a-15(e) or 15d-15(e).
31.2	Certification of the Chief Financial Officer of Periodic Report Pursuant to Rule 13a-15(e) or 15d-15(e).
32	Certification by Chief Executive Officer and Chief Financial Officer of Periodic Report Pursuant to 18 U.S.C. Section 1350.
99	Summary of Non-Employee Director Compensation and Benefits