

CONEXANT SYSTEMS INC

Form 10-Q

May 04, 2007

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

**FORM 10-Q**

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

**For the Quarterly Period Ended March 30, 2007**

**OR**

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

**Commission file number: 000-24923**

**CONEXANT SYSTEMS, INC.**

(Exact name of registrant as specified in its charter)

**Delaware**

(State of incorporation)

**25-1799439**

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

**4000 MacArthur Boulevard**

**Newport Beach, California 92660-3095**

(Address of principal executive offices) (Zip code)

**(949) 483-4600**

(Registrant's telephone number, including area code)

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

Yes  No

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

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

Yes  No

As of April 27, 2007, there were 490,488,494 shares of the registrant's common stock outstanding.

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**FORWARD-LOOKING STATEMENTS**

In addition to historical information, this Quarterly Report on Form 10-Q contains statements relating to future results of Conexant Systems, Inc. (including certain projections and business trends) that are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, and are subject to the safe harbor created by those sections. Our actual results may differ materially from those projected as a result of certain risks and uncertainties. These risks and uncertainties include, but are not limited to:

pricing pressures and other competitive factors;

the timing of our new product introductions and product quality;

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

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

the substantial losses we have incurred recently;

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

continuing volatility in the technology sector and the semiconductor industry;

demand for and market acceptance of new and existing products;

successful development of new products;

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

the availability of manufacturing capacity;

changes in product mix;

the risk that capital needed for our business and to repay our indebtedness will not be available when needed;

product obsolescence;

the ability of our customers to manage inventory;

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

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

possible disruptions in commerce related to terrorist activity or armed conflict, as well as other risks and uncertainties, including those set forth herein and those detailed from time to time in our other Securities and Exchange Commission filings. These forward-looking statements are made only as of the date hereof, and we undertake no obligation to update or revise the forward-looking statements, whether as a result of new

information, future events or otherwise, except as otherwise required by law.

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(unaudited, in thousands, except par value)**

	<b>March 30, 2007</b>	<b>September 29, 2006</b>
<b>ASSETS</b>		
<b>Current assets:</b>		
Cash and cash equivalents	\$ 170,367	\$ 225,626
Marketable securities	63,888	115,709
Restricted cash	8,800	8,800
Receivables, net of allowances of \$1,720 and \$842	110,725	123,025
Inventories, net	76,504	97,460
Other current assets	25,544	19,353
<b>Total current assets</b>	<b>455,828</b>	<b>589,973</b>
Property, plant and equipment, net	68,572	65,405
Goodwill	580,694	710,790
Intangible assets, net	45,945	76,008
Other assets	97,098	131,449
<b>Total assets</b>	<b>\$ 1,248,137</b>	<b>\$ 1,573,625</b>
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
<b>Current liabilities:</b>		
Current portion of long-term debt	\$ 46,500	\$ 188,375
Short-term debt	80,000	80,000
Accounts payable	95,105	113,690
Accrued compensation and benefits	24,602	28,307
Other current liabilities	46,274	51,966
<b>Total current liabilities</b>	<b>292,481</b>	<b>462,338</b>
Long-term debt	478,500	518,125
Other liabilities	71,100	83,064
<b>Total liabilities</b>	<b>842,081</b>	<b>1,063,527</b>
Commitments and contingencies (Note 4)		
<b>Shareholders equity:</b>		
Preferred and junior preferred stock	4,904	4,866

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Common stock, \$0.01 par value: 1,000,000 shares authorized; 490,353 and 486,482 shares issued; and 490,353 and 485,200 shares outstanding		
Treasury stock: zero and 1,282 shares, at cost		(5,823)
Additional paid-in capital	4,709,847	4,699,029
Accumulated deficit	(4,308,227)	(4,175,757)
Accumulated other comprehensive loss	(367)	(12,096)
Shareholder notes receivable	(101)	(121)
Total shareholders equity	406,056	510,098
Total liabilities and shareholders equity	\$ 1,248,137	\$ 1,573,625

See accompanying notes to condensed consolidated financial statements.

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

	Three Months Ended		Six Months Ended	
	March 30, 2007	March 31, 2006	March 30, 2007	March 31, 2006
Net revenues	\$ 199,865	\$ 242,583	\$ 445,399	\$ 473,289
Cost of goods sold <sup>(1)</sup>	110,016	136,373	246,061	271,326
Gross margin	89,849	106,210	199,338	201,963
Operating expenses:				
Research and development <sup>(1)</sup>	69,345	64,831	140,795	129,190
Selling, general and administrative <sup>(1)</sup>	26,803	36,320	54,279	74,921
Amortization of intangible assets	6,254	7,758	12,492	15,665
Special charges	160,121	38,854	163,019	39,769
Total operating expenses	262,523	147,763	370,585	259,545
Operating loss	(172,674)	(41,553)	(171,247)	(57,582)
Interest expense	(13,220)	(10,052)	(26,256)	(18,854)
Other income, net	9,660	42,792	22,721	46,139
Loss before income taxes and gain (loss) of equity method investments	(176,234)	(8,813)	(174,782)	(30,297)
Provision for income taxes	1,232	735	1,703	1,451
Loss before gain (loss) of equity method investments	(177,466)	(9,548)	(176,485)	(31,748)
Gain (loss) of equity method investments	44,020	(584)	44,015	(2,655)
Net loss	\$ (133,446)	\$ (10,132)	\$ (132,470)	\$ (34,403)
Net loss per share basic and diluted	\$ (0.27)	\$ (0.02)	\$ (0.27)	\$ (0.07)
Shares used in basic and diluted per-share computations	489,302	477,480	487,630	475,761



- (1) These captions include non-cash employee stock-based compensation expense as follows (see Note 1):

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>March 30,</b>	<b>March 31,</b>	<b>March 30,</b>	<b>March 31,</b>
	<b>2007</b>	<b>2006</b>	<b>2007</b>	<b>2006</b>
Cost of goods sold	\$ 115	\$ 131	\$ 218	\$ 429
Research and development	2,715	5,858	5,082	11,148
Selling, general and administrative	1,941	6,763	3,808	15,491

See accompanying notes to condensed consolidated financial statements.

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

	<b>Six Months Ended</b>	
	<b>March 30, 2007</b>	<b>March 31, 2006</b>
<b>Cash flows from operating activities:</b>		
Net loss	\$ (132,470)	\$ (34,403)
Adjustments to reconcile net loss to net cash (used in) provided by operating activities, net of effects of acquisitions:		
Depreciation	11,989	9,104
Amortization of intangible assets	12,492	15,665
Asset impairments	155,000	
Reversal of provision for bad debts, net	(219)	(2,243)
(Reversal of) charges for inventory provisions, net	(3,256)	58
Stock-based compensation	9,108	27,068
Increase in fair value of derivative instruments	(6,924)	(31,331)
(Gains) losses of equity method investments	(44,015)	2,655
Gains on sales of equity securities and other assets	(6,190)	(4,414)
Other items, net	(363)	(609)
Changes in assets and liabilities:		
Receivables	12,519	(13,602)
Inventories	25,451	7,784
Accounts payable	(19,586)	23,058
Accrued expenses and other current liabilities	(14,456)	38,905
Other, net	(7,306)	(23,412)
Net cash (used in) provided by operating activities	(8,226)	14,283
<b>Cash flows from investing activities:</b>		
Payments for acquisitions, net of cash acquired	(5,029)	(6,900)
Proceeds from equity securities and other assets	105,491	5,200
Purchases of equity securities	(600)	(1,848)
Proceeds from sales and maturities of marketable securities	78,645	61,944
Purchases of marketable securities	(25,877)	(26,473)
Purchases of property, plant and equipment	(14,939)	(13,139)
Restricted cash		(8,800)
Net cash provided by investing activities	137,691	9,984
<b>Cash flows from financing activities:</b>		
Proceeds from short-term debt, net of expenses of \$1,198 and \$1,534	(1,198)	78,466
Proceeds from long-term debt, net of expenses of \$9,249 and \$4,910	265,751	195,090
Repurchases and retirements of long-term debt	(456,500)	(57,859)
Proceeds from issuance of common stock	7,202	11,964

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Repayment of shareholder notes receivable	21	163
Net cash (used in) provided by financing activities	(184,724)	227,824
Net (decrease) increase in cash and cash equivalents	(55,259)	252,091
Cash and cash equivalents at beginning of period	225,626	202,704
Cash and cash equivalents at end of period	\$ 170,367	\$ 454,795

See accompanying notes to condensed consolidated financial statements.

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**CONEXANT SYSTEMS, INC. AND SUBSIDIARIES**  
**Notes to Condensed Consolidated Financial Statements**  
**(unaudited)**

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

Conexant Systems, Inc. (Conexant or the Company) designs, develops and sells semiconductor system solutions, comprised of semiconductor devices, software and reference designs, for use in broadband communications applications that enable high-speed transmission, processing and distribution of audio, video, voice and data to, and throughout, homes and business enterprises worldwide. The Company's access solutions connect people through personal communications access products, such as personal computers (PCs) and television set-top boxes (STBs), to audio, video, voice and data services over wireless and wire line broadband connections, as well as over dial-up Internet connections. The Company's central office solutions are used by service providers to deliver high-speed audio, video, voice and data services over copper telephone lines and fiber optic networks to homes and businesses around the world. 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. These solutions enable broadband connections and network content to be shared throughout a home or small office-home office environment using a variety of communications devices, which the Company describes as the broadband digital home.

**Interim Reporting** The accompanying unaudited condensed consolidated financial statements have been prepared by the Company in accordance with accounting principles generally accepted in the United States of America and with the instructions to Form 10-Q and Article 10 of Regulation S-X of the Securities and Exchange Commission. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, the accompanying unaudited condensed consolidated financial statements contain all adjustments, consisting of adjustments of a normal recurring nature, as well as special charges, necessary to present fairly the Company's financial position, results of operations and cash flows. The results of operations for interim periods are not necessarily indicative of the results that may be expected for a full year. These statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended September 29, 2006.

**Fiscal Periods** The Company's fiscal year is the 52- or 53-week period ending on the Friday closest to September 30. In a 52-week year, each fiscal quarter consists of 13 weeks. The additional week in a 53-week year is added to the fourth quarter, making such quarter consist of 14 weeks. Fiscal 2006 was a 52-week year, and fiscal 2007 will also consist of 52 weeks.

**Supplemental Cash Flow Information** Cash paid for interest was \$23.1 million and \$16.5 million for the six months ended March 30, 2007 and March 31, 2006, respectively. Cash paid for income taxes for the six months ended March 30, 2007 and March 31, 2006 was \$1.0 million and \$0.8 million, respectively.

**Revenue Recognition** The Company recognizes revenue when (i) persuasive evidence of an arrangement exists, (ii) delivery has occurred, (iii) the sales price and terms are fixed and determinable, and (iv) collection of the receivable is reasonably assured. These terms are typically met upon shipment of product to the customer, except for certain distributors who have unlimited contractual rights of return or for whom the contractual terms were not enforced, or when significant vendor obligations exist. Revenue with respect to sales to distributors with unlimited rights of return or for whom contractual terms were not enforced is deferred until the products are sold by the distributors to third parties. At March 30, 2007 and September 29, 2006, deferred revenue related to sales to these distributors was \$5.7 million and \$6.7 million, respectively. Revenue with respect to sales to customers to whom the Company has significant obligations after delivery is deferred until all significant obligations have been completed. At March 30, 2007 and September 29, 2006, deferred revenue related to shipments of products for which the Company has on-going performance obligations was \$3.8 million and \$6.6 million, respectively. The majority of the Company's distributors have limited stock rotation rights, which allow them to rotate up to 10% of product in their inventory two times a year. The Company recognizes revenue to these distributors upon shipment of product to the distributor, as the stock rotation rights are limited and the Company believes that it has the ability to reasonably estimate and establish allowances for expected product returns in accordance with Statement of Financial Accounting Standards (SFAS) No. 48, Revenue Recognition When Right of Return Exists. Development revenue is recognized when

services are performed and was not significant for any periods presented.

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

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**CONEXANT SYSTEMS, INC. AND SUBSIDIARIES**  
**Notes to Condensed Consolidated Financial Statements**  
**(unaudited)**

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

***Cash and Cash Equivalents*** The Company considers all highly liquid investments with insignificant interest rate risk and original maturities of three months or less from the date of purchase to be cash equivalents. The carrying amounts of cash and cash equivalents approximate their fair values.

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

***Restricted Cash*** Restricted cash represents amounts used to collateralize a consolidated subsidiary's obligations under an \$80.0 million credit facility with a bank. See Note 3 for further information regarding the credit facility.

***Stock-Based Compensation*** In December 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 123(R), Share-Based Payment. This pronouncement amended SFAS No. 123, Accounting for Stock-Based Compensation, and superseded Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees. SFAS No. 123(R) requires that companies account for awards of equity instruments issued to employees under the fair value method of accounting and recognize such amounts in their statements of operations. The Company adopted SFAS No. 123(R) on October 1, 2005. Under SFAS No. 123(R), the Company is required to measure compensation cost for all stock-based awards at fair value on the date of grant and recognize compensation expense in its consolidated statements of operations over the service period that the awards are expected to vest. As permitted under SFAS No. 123(R), the Company elected to recognize compensation cost for all options with graded vesting granted on or after October 1, 2005 on a straight-line basis over the vesting period of the entire option. For options with graded vesting granted prior to October 1, 2005, the Company will continue to recognize compensation cost over the vesting period following the accelerated recognition method described in FASB Interpretation No. 28, Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans, as if each underlying vesting date represented a separate option grant.

Under SFAS No. 123(R), the Company records in its consolidated statements of operations (i) compensation cost for options granted, modified, repurchased or cancelled on or after October 1, 2005 under the provisions of SFAS No. 123(R) and (ii) compensation cost for the unvested portion of options granted prior to October 1, 2005 over their remaining vesting periods using the amounts previously measured under SFAS No. 123 for pro forma disclosure purposes.

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

future periods.

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**CONEXANT SYSTEMS, INC. AND SUBSIDIARIES**  
**Notes to Condensed Consolidated Financial Statements**  
**(unaudited)**

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

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>March 30, 2007</b>	<b>March 31, 2006</b>	<b>March 30, 2007</b>	<b>March 31, 2006</b>
Stock option plans:				
Expected dividend yield	0%	0%	0%	0%
Expected stock price volatility	70%	76%	71%	76%
Risk-free interest rate	4.7%	4.4%	4.7%	4.4%
Average expected life (in years)	5.25	5.25	5.25	5.25
Stock purchase plan:				
Expected dividend yield	0%	0%	0%	0%
Expected stock price volatility	53%	76%	53%	76%
Risk-free interest rate	4.7%	4.4%	4.7%	4.4%
Average expected life (in years)	0.50	0.50	0.50	0.50

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

**Derivative Financial Instruments** The Company's derivative financial instruments as of March 30, 2007 principally consist of (i) the Company's warrant to purchase 30 million shares of Mindspeed Technologies, Inc. (Mindspeed) common stock and (ii) foreign currency forward exchange contracts. See Note 3 for further information regarding the Mindspeed warrant.

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

At March 30, 2007, the Company had outstanding foreign currency forward exchange contracts with a notional amount of 790.0 million Indian Rupees, approximately \$17.3 million, maturing at various dates through October 2007. Based on the fair values of these contracts, the Company recorded a derivative asset of \$0.7 million at March 30, 2007. During the three and six months ended March 30, 2007 and March 31, 2006, there were no significant gains or losses recognized in the statements of operations for hedge ineffectiveness.





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**CONEXANT SYSTEMS, INC. AND SUBSIDIARIES**  
**Notes to Condensed Consolidated Financial Statements**  
**(unaudited)**

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

**Net Loss Per Share** Net loss per share is computed in accordance with SFAS No. 128, Earnings Per Share. Basic net loss per share is computed by dividing net loss by the weighted average number of common shares outstanding during the period. Diluted net loss per share is computed by dividing net loss by the weighted average number of common shares outstanding and potentially dilutive securities outstanding during the period. Potentially dilutive securities include stock options and warrants and shares of stock issuable upon conversion of the Company's convertible subordinated notes. The dilutive effect of stock options and warrants is computed under the treasury stock method, and the dilutive effect of convertible subordinated notes is computed using the if-converted method. Potentially dilutive securities are excluded from the computations of diluted net loss per share if their effect would be antidilutive. The following potentially dilutive securities have been excluded from the diluted net loss per share calculations because their effect would have been antidilutive (in thousands):

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>March 30, 2007</b>	<b>March 31, 2006</b>	<b>March 30, 2007</b>	<b>March 31, 2006</b>
Stock options and warrants	5,486	15,559	6,065	9,883
5.25% convertible subordinated notes due May 2006		5,840		5,840
4.25% convertible subordinated notes due May 2006		7,364		7,364
4.00% convertible subordinated notes due February 2007	3,890	11,796	7,318	11,967
4.00% convertible subordinated notes due March 2026	50,813	11,168	50,813	5,584
	60,189	51,727	64,196	40,638

**Business Enterprise Segments** The Company operates in one reportable segment, broadband communications. 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 consolidated financial statements.

Although the Company had four operating segments at March 30, 2007, under the aggregation criteria set forth in SFAS No. 131, the Company only operates in one reportable segment, broadband communications.

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

the nature of products and services;

the nature of the production processes;

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

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

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

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

the products sold by each of our operating segments use the same 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 the Company meets each of the criteria set forth above and each of its operating segments has similar economic characteristics, the Company aggregates its results of operations in one reportable segment.

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**CONEXANT SYSTEMS, INC. AND SUBSIDIARIES**  
**Notes to Condensed Consolidated Financial Statements**  
**(unaudited)**

***Recent Accounting Pronouncements*** In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities, which permits entities to choose to measure at fair value eligible financial instruments and certain other items that are not currently required to be measured at fair value. The standard requires that unrealized gains and losses on items for which the fair value option has been elected be reported in earnings at each subsequent reporting date. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. The Company will adopt SFAS No. 159 no later than the first quarter of fiscal 2009. The Company is currently assessing the impact the adoption of SFAS No. 159 will have on its financial position and results of operations.

In September 2006, the FASB issued SFAS No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106, and 132(R). SFAS No. 158 requires company plan sponsors to display the net over- or under-funded position of a defined benefit postretirement plan as an asset or liability, with any unrecognized prior service costs, transition obligations or actuarial gains/losses reported as a component of other comprehensive income in shareholders equity. SFAS No. 158 is effective for fiscal years ending after December 15, 2006. The Company will adopt SFAS No. 158 as of the end of fiscal 2007. The Company is currently assessing the impact the adoption of SFAS No. 158 will have on its financial position and results of operations.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements. SFAS No. 157 establishes a framework for measuring fair value in generally accepted accounting principles, clarifies the definition of fair value and expands disclosures about fair value measurements. SFAS No. 157 does not require any new fair value measurements. However, the application of SFAS No. 157 may change current practice for some entities. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company will adopt SFAS No. 157 in the first quarter of fiscal 2009. The Company is currently assessing the impact the adoption of SFAS No. 157 will have on its financial position and results of operations.

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin (SAB) No. 108 on Quantifying Misstatements. SAB No. 108 requires companies to use both a balance sheet and an income statement approach when quantifying and evaluating the materiality of a misstatement, and contains guidance on correcting errors under the dual approach. SAB No. 108 also provides transition guidance for correcting errors existing in prior years. SAB No. 108 is effective for annual financial statements covering the first fiscal year ending after November 15, 2006, with earlier application encouraged for any interim period of the first fiscal year ending after November 15, 2006, and filed after September 13, 2006. The Company is currently assessing the impact, if any, SAB No. 108 will have on its financial position and results of operations.

In July 2006, the FASB issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 (FIN 48). This interpretation clarifies the application of SFAS No. 109, Accounting for Income Taxes, by defining a criterion that an individual tax position must meet for any part of the benefit of that position to be recognized in an enterprise s financial statements and also provides guidance on measurement, derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006, but earlier adoption is permitted. The Company will adopt FIN 48 no later than the first quarter of fiscal 2008. The Company is currently assessing the impact the adoption of FIN 48 will have on its financial position and results of operations.

***Reclassification*** The Company has reclassified its share of the earnings and losses of its equity method investments from other income, net to a separate line item between provision for income taxes and net income (loss) on its statements of operations for the three and six months ended March 31, 2006 to conform to the current period presentation. This reclassification on the statement of operations did not affect the Company s reported revenues, gross margin, operating loss or net loss for either period. The following is a reconciliation of other income, net before and after the reclassification (in thousands):



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	<b>Three Months Ended March 31, 2006</b>	<b>Six Months Ended March 31, 2006</b>
Other income, net, before reclassification	\$ 42,208	\$ 43,484
Losses of equity method investments	584	2,655
Other income, net, after reclassification	\$ 42,792	\$ 46,139

**2. Business Combination**

In October 2006, the Company acquired the assets of Zarlink Semiconductor Inc.'s (Zarlink) packet switching business. Zarlink's team of digital switching logic engineers is now part of the Company's Broadband Access group and is based in the Company's headquarters in Newport Beach, California. This acquisition was accounted for using the purchase method of accounting in accordance with SFAS No. 141, Business Combinations. The Company's consolidated statements of operations include the effect of this transaction from the date of acquisition. The pro forma effect of this transaction was not material to the Company's statements of operations for the three and six months ended March 30, 2007 and March 31, 2006.

The aggregate purchase price for this acquisition was \$5.0 million. Of this purchase price, approximately \$0.7 million was allocated to net tangible assets, approximately \$2.4 million was allocated to identifiable intangible assets, and the remaining \$1.9 million was allocated to goodwill. The identifiable intangible assets are being amortized on a straight-line basis over their useful lives of eight years. The terms of this acquisition include provisions under which Zarlink could receive additional consideration of up to \$2.5 million through December 31, 2008 if certain revenue targets are achieved. This contingent consideration has not been included in the purchase price allocation and, if earned, such amounts will be recorded as additional goodwill.

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

Available-for-sale securities consist of the following (in thousands):

	<b>Cost or Amortized Cost</b>	<b>Gross Unrealized Holding Gains</b>	<b>Gross Unrealized Holding Losses</b>	<b>Fair Value</b>
<b>March 30, 2007:</b>				
Corporate debt securities	\$ 4,563	\$ 29	\$	\$ 4,592
U.S. government agency securities	16,204	187		16,391
Equity securities	44,063	1,484	(2,642)	42,905
	\$ 64,830	\$ 1,700	\$ (2,642)	\$ 63,888
<b>September 29, 2006:</b>				
Corporate debt securities	\$ 22,719	\$ 30	\$ (29)	\$ 22,720
U.S. government agency securities	60,777	134	(11)	60,900
Equity securities	34,068		(1,979)	32,089

\$ 117,564      \$            164      \$            (2,019)      \$ 115,709

The Company's marketable equity securities at March 30, 2007 and September 29, 2006 include 6.2 million shares of Skyworks Solutions, Inc. (Skyworks) common stock. The Company's cost basis in the Skyworks shares is \$5.51 per share, and the market value at March 30, 2007 was \$5.75 per share. The Company's marketable equity securities at March 30, 2007 also include 1.7 million shares of Jazz Technologies, Inc. (Jazz Technologies) common stock, which were purchased in February 2007. The Company's cost basis in these shares is \$5.85 per share, and the market value at March 30, 2007 was \$4.30 per share. The \$2.6 million aggregate decrease in the fair value of the Jazz Technologies shares has been recorded in accumulated other comprehensive income (loss) on the Company's consolidated balance sheet at March 30, 2007.

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**Inventories**

Inventories consist of the following (in thousands):

	<b>March 30, 2007</b>	<b>September 29, 2006</b>
Work-in-process	\$ 32,368	\$ 53,884
Finished goods	44,136	43,576
	<b>\$ 76,504</b>	<b>\$ 97,460</b>

At March 30, 2007 and September 29, 2006, inventories were net of excess and obsolete (E&O) inventory reserves of \$26.6 million and \$36.6 million, respectively. In addition, at March 30, 2007 and September 29, 2006, inventories were net of lower of cost or market (LCM) reserves of \$0.7 million and \$1.8 million, respectively.

**Goodwill**

The changes in the carrying amount of goodwill for the six months ended March 30, 2007 were as follows (in thousands):

Goodwill at September 29, 2006	\$ 710,790
Impairment	(135,000)
Additions	1,921
Other adjustments	2,983
Goodwill at March 30, 2007	\$ 580,694

Goodwill is tested on an annual basis and between annual tests whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. Major cellular handset manufacturers have recently accelerated their timelines for incorporating the emerging combination Bluetooth-WiFi products into their roadmaps, which decreased the revenue outlook related to the Company's existing design wins. Further, the Company has decided not to pursue the development of these combination products due to the high level of research and development effort required. As a result of these events, the Company reduced its revenue forecast for wireless products targeted at the cellular handset market. Due to this reduced revenue forecast, the Company performed a goodwill impairment test for its Embedded Wireless Networking (EWN) reporting unit during the three months ended March 30, 2007. The fair value of the EWN reporting unit was determined using a combination of a discounted cash flow model and a revenue multiple model. As a result of this impairment test, the Company recorded an impairment charge of \$135.0 million related to the goodwill in its EWN reporting unit. This impairment charge is included in special charges in the accompanying condensed consolidated statements of operations for the three and six months ended March 30, 2007.

The Company also recorded \$1.9 million of additional goodwill as a result of the acquisition of the assets of Zarlink's packet switching business in October 2006. See Note 2 for further information regarding the Zarlink acquisition.

**Intangible Assets**

Intangible assets consist of the following (in thousands):

	<b>March 30, 2007</b>			<b>September 29, 2006</b>		
	<b>Gross Carrying Amount</b>	<b>Accumulated Amortization</b>	<b>Book Value</b>	<b>Gross Carrying Amount</b>	<b>Accumulated Amortization</b>	<b>Book Value</b>



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Developed technology	\$ 125,614	\$ (85,435)	\$ 40,179	\$ 139,483	\$ (74,477)	\$ 65,006
Product licenses	9,327	(6,050)	3,277	12,769	(5,263)	7,506
Other intangible assets	6,015	(3,526)	2,489	7,015	(3,519)	3,496
	\$ 140,956	\$ (95,011)	\$ 45,945	\$ 159,267	\$ (83,259)	\$ 76,008

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

	<b>Remainder of 2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>Thereafter</b>
Amortization expense	\$9,607	\$18,853	\$11,123	\$4,638	\$679	\$1,045

Intangible assets are continually monitored and reviewed for impairment whenever events or changes in circumstances indicate that their carrying amounts may not be recoverable. Due to the reduced revenue forecast for wireless products discussed above, the Company performed an impairment test for its EWN intangible assets during the three months ended March 30, 2007. The fair values of the intangible assets were determined using a discounted cash flow model.

As a result of this impairment test, the Company recorded an impairment charge of \$20.0 million related to the intangible assets in its EWN business, including the 802.11b, 802.11g and 802.11a/b/g developed technologies acquired in its merger with GlobespanVirata, Inc. in February 2004. This impairment charge is included in special charges in the accompanying condensed consolidated statements of operations for the three and six months ended March 30, 2007.

**Mindspeed Warrant**

The Company has a warrant to purchase 30 million shares of Mindspeed common stock at an exercise price of \$3.408 per share through June 2013. At March 30, 2007 and September 29, 2006, the market value of Mindspeed's common stock was \$2.17 and \$1.73 per share, respectively. 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 March 30, 2007 and September 29, 2006, the aggregate fair value of the Mindspeed warrant included in other assets on the accompanying condensed consolidated balance sheets was \$23.4 million and \$16.5 million, respectively. At March 30, 2007, the warrant was valued using the Black-Scholes-Merton model with expected terms for portions of the warrant varying from 1 to 5 years, expected volatility of 75%, a weighted average risk-free interest rate of 4.6% and no dividend yield. The aggregate fair value of the warrant is reflected as a long-term asset on the accompanying condensed consolidated balance sheets because the Company does not intend to liquidate any portion of the warrant in the next twelve months.

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

**Short-Term Debt**

On November 29, 2005, the Company established an accounts receivable financing facility whereby it sells, from time to time, certain accounts receivable to Conexant USA, LLC (Conexant USA), a special purpose entity which is a consolidated subsidiary of the Company. Under the terms of the Company's agreements with Conexant USA, the Company retains the responsibility to service and collect accounts receivable sold to Conexant USA and receives a weekly fee from Conexant USA for handling administrative matters which is equal to 1.0%, on a per annum basis, of the uncollected value of the accounts receivable.

Concurrent with the Company's agreements with Conexant USA, Conexant USA entered into an \$80.0 million revolving credit agreement with a bank which is secured by the assets of Conexant USA. This credit agreement had an initial term of 364 days, and in November 2006, the term of the credit agreement was extended through November 28, 2007. The credit agreement remains subject to additional 364-day renewal periods at the discretion of the bank.

Conexant USA is required to maintain certain minimum amounts on deposit (restricted cash) with the bank during the term of the credit agreement. Borrowings under the credit agreement, which cannot exceed the lesser of \$80.0 million and 85% of the uncollected value of purchased accounts receivable that are eligible for coverage under an insurance policy for the receivables, will bear interest equal to 7-day LIBOR (reset quarterly) plus 0.6%. Additionally, Conexant

USA will pay a fee of 0.2% per annum for the unused portion of the line of credit.

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The credit agreement requires the Company and its consolidated subsidiaries to maintain minimum levels of shareholders' equity and cash and cash equivalents. Further, any failure by the Company or Conexant USA to pay their respective debts as they become due would allow the bank to terminate the credit agreement and cause all borrowings under the credit agreement to immediately become due and payable. At March 30, 2007, Conexant USA had \$15.0 million of cash, \$8.8 million of restricted cash and \$76.5 million of accounts receivable, all of which serve as collateral under the credit agreement. At March 30, 2007, Conexant USA had borrowed \$80.0 million under this credit agreement and the Company was in compliance with all financial covenants. During the six months ended March 30, 2007, the Company incurred fees of \$1.2 million in connection with the extension of the credit agreement.

**Long-Term Debt**

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

	<b>March 30, 2007</b>	<b>September 29, 2006</b>
Floating rate senior secured notes due November 2010	\$ 275,000	\$
4.00% convertible subordinated notes due March 2026	250,000	250,000
4.00% convertible subordinated notes due February 2007		456,500
<b>Total</b>	<b>525,000</b>	<b>706,500</b>
Less: current portion of long-term debt	(46,500)	(188,375)
<b>Long-term debt</b>	<b>\$ 478,500</b>	<b>\$ 518,125</b>

**Floating rate senior secured notes due November 2010** In November 2006, the Company issued \$275.0 million aggregate principal amount of floating rate senior secured notes due November 2010. Proceeds from this issuance, net of fees paid or payable, were approximately \$265.1 million. The senior secured notes bear interest at three-month LIBOR (reset quarterly) plus 3.75%, and interest is payable in arrears quarterly on each February 15, May 15, August 15 and November 15, beginning on February 15, 2007. The senior secured notes are redeemable in whole or in part, at the option of the Company, at any time on or after November 15, 2008 at varying redemption prices that generally include premiums, which are defined in the indenture for the notes, plus accrued and unpaid interest. At any time prior to November 15, 2008, the Company may redeem up to 35% of the senior secured notes with proceeds of one or more offerings of the Company's common stock at a redemption price equal to 100% of the aggregate principal amount thereof plus accrued and unpaid interest. The Company is required to offer to repurchase, for cash, notes at a price of 100% of the principal amount, plus any accrued and unpaid interest, with the net proceeds of certain asset dispositions if such proceeds are not used within 360 days to invest in assets (other than current assets) related to the Company's business. In addition, upon a change of control, the Company is required to make an offer to redeem all of the senior secured notes at a redemption price equal to 101% of the aggregate principal amount thereof plus accrued and unpaid interest. The floating rate senior secured notes rank equally in right of payment with all of the Company's existing and future senior debt and senior to all of its existing and future subordinated debt. The notes are guaranteed by certain of the Company's U.S. subsidiaries (the Subsidiary Guarantors). The guarantees rank equally in right of payment with all of the Subsidiary Guarantors' existing and future senior debt and senior to all of the Subsidiary Guarantors' existing and future subordinated debt. The notes and guarantees (and certain hedging obligations that may be entered into with respect thereto) are secured by first-priority liens, subject to permitted liens, on substantially all of the Company's and the Subsidiary Guarantors' assets (other than accounts receivable and proceeds therefrom and subject to certain exceptions), including, but not limited to, the intellectual property, owned real property, plant and equipment now owned or hereafter acquired by the Company and the Subsidiary Guarantors. See Note 11 for

condensed financial information regarding the Subsidiary Guarantors.

The indenture governing the senior secured notes contains a number of covenants that restrict, subject to certain exceptions, the Company's ability and the ability of its restricted subsidiaries to: incur or guarantee additional indebtedness or issue certain redeemable or preferred stock; repurchase capital stock; pay dividends on or make

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other distributions in respect of its capital stock or make other restricted payments; make certain investments; create liens; redeem junior debt; sell certain assets; consolidate, merge, sell or otherwise dispose of all or substantially all of its assets; enter into certain types of transactions with affiliates; and enter into sale-leaseback transactions.

The sale of the Company's investment in Jazz Semiconductor in February 2007 and the sale of two other equity investments in January 2007 qualify as asset dispositions requiring the Company to make offers to repurchase a portion of the notes no later than 361 days following the respective asset dispositions. Based on the proceeds received from these asset dispositions and the Company's estimates of cash investments in assets (other than current assets) related to the Company's business to be made within 360 days following the asset dispositions, the Company estimates that it will be required to make offers to repurchase approximately \$46.5 million of the senior secured notes, at 100% of the principal amount plus any accrued and unpaid interest, in the second quarter of fiscal 2008. As a result, \$46.5 million of the senior secured notes have been classified as current liabilities on the accompanying condensed consolidated balance sheet at March 30, 2007.

At March 30, 2007, the fair value of the floating rate senior secured notes, based on quoted market prices, was approximately \$284.6 million compared to their carrying value of \$275.0 million.

**4.00% convertible subordinated notes due March 2026** In March 2006, the Company issued \$200.0 million aggregate principal amount of 4.00% convertible subordinated notes due March 2026 and, in May 2006, the initial purchaser of the notes exercised its option to purchase an additional \$50.0 million principal amount of the 4.00% convertible subordinated notes due March 2026. Total proceeds from these issuances, net of issuance costs, were \$243.6 million. The notes are general unsecured obligations of the Company. Interest on the notes is payable in arrears semiannually on each March 1 and September 1, beginning on September 1, 2006. The notes are convertible, at the option of the holder upon satisfaction of certain conditions, into shares of the Company's common stock at a conversion price of \$4.92 per share, subject to adjustment for certain events. Upon conversion, the Company has the right to deliver, in lieu of common stock, cash or a combination of cash and common stock. Beginning on March 1, 2011, the notes may be redeemed at the Company's option at a price equal to 100% of the principal amount, plus any accrued and unpaid interest. Holders may require the Company to repurchase, for cash, all or part of their notes on March 1, 2011, March 1, 2016 and March 1, 2021 at a price of 100% of the principal amount, plus any accrued and unpaid interest.

At March 30, 2007, the fair value of the 4.00% convertible subordinated notes due March 2026, based on quoted market prices, was approximately \$220.2 million compared to their carrying value of \$250.0 million.

**4.00% convertible subordinated notes due February 2007** In February 2000, the Company issued \$650.0 million aggregate principal amount of 4.00% convertible subordinated notes due February 2007 for proceeds, net of issuance costs, of approximately \$631.0 million. The notes were general unsecured obligations of the Company. Interest on the notes was payable in arrears semiannually on each February 1 and August 1. The notes were convertible, at the option of the holder, at any time prior to redemption or maturity into shares of the Company's common stock at a conversion price of \$42.43 per share, subject to adjustment for certain events. The notes were subject to redemption at the Company's option at a declining premium to par. During fiscal 2001, 2003 and 2006, the Company purchased \$35.0 million, \$100.0 million and \$58.5 million, respectively, principal amount of these notes at prevailing market prices. In February 2007, the Company retired the remaining \$456.5 million principal amount of these notes at maturity.

#### **4. Commitments and Contingencies**

##### **Lease Commitments**

The Company leases certain facilities and equipment under non-cancelable operating leases which expire at various dates through 2021 and contain various provisions for rental adjustments including, in certain cases, adjustments based on increases in the Consumer Price Index. The leases generally contain renewal provisions for varying periods of time. Rental expense under operating leases was approximately \$6.4 million and \$8.0 million for the six months ended March 30, 2007 and March 31, 2006, respectively.



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At March 30, 2007, future minimum lease payments and related sublease income under operating leases were as follows (in thousands):

<b>Fiscal Year</b>	<b>Lease Payments</b>	<b>Sublease Income</b>	<b>Net Obligation</b>
Remainder of 2007	\$ 14,977	\$ (4,373)	\$ 10,604
2008	25,520	(7,166)	18,354
2009	18,009	(3,384)	14,625
2010	16,433	(3,330)	13,103
2011	14,208	(2,178)	12,030
Thereafter	63,110	(5,582)	57,528
<b>Total</b>	<b>\$ 152,257</b>	<b>\$ (26,013)</b>	<b>\$ 126,244</b>

The summary of future minimum lease payments includes an aggregate gross amount of \$54.9 million of lease obligations that principally expire through fiscal 2021, which have been accrued for in connection with the Company's reorganization and restructuring actions and previous actions taken by GlobespanVirata, Inc. prior to its merger with the Company in February 2004. See Note 7 for further information regarding restructuring actions.

At March 30, 2007, the Company is also contingently liable for approximately \$3.8 million in operating lease commitments on facility leases that were assigned to Mindspeed and Skyworks at the time of their separation from the Company.

**Legal Matters**

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

***IPO Litigation*** In November 2001, Collegeware Asset Management, LP, on behalf of itself and a putative class of persons who purchased the common stock of GlobeSpan, Inc. (GlobeSpan, Inc. later became GlobespanVirata, Inc., and is now the Company's Conexant, Inc. subsidiary) between June 23, 1999 and December 6, 2000, filed a complaint in the U.S. District Court for the Southern District of New York alleging violations of federal securities laws by the underwriters of GlobeSpan, Inc.'s initial and secondary public offerings as well as by certain GlobeSpan, Inc. officers and directors. The complaint alleges that the defendants violated federal securities laws by issuing and selling GlobeSpan, Inc.'s common stock in the initial and secondary offerings without disclosing to investors that the underwriters had (1) solicited and received undisclosed and excessive commissions or other compensation and (2) entered into agreements requiring certain of their customers to purchase the stock in the aftermarket at escalating prices. The complaint seeks unspecified damages. The complaint was consolidated with class actions against approximately 300 other companies making similar allegations regarding the public offerings of those companies during 1998 through 2000. In June 2003, Conexant, Inc. and the named officers and directors entered into a memorandum of understanding outlining a settlement agreement with the plaintiffs that will, among other things, result in the dismissal with prejudice of all the claims against the former GlobeSpan, Inc. officers and directors. The final settlement was executed in June 2004. On February 15, 2005, the District Court issued a decision certifying a



class action for settlement purposes and granting preliminary approval of the settlement, subject to modification of certain bar orders contemplated by the settlement, which bar orders have since been modified. On December 5, 2006, the U.S. Court of Appeals for the Second Circuit reversed the lower court, ruling that no class was properly certified. It is not yet clear what impact this decision will have on the issuers' settlement. The settlement remains subject to a number of conditions and final approval. It is possible that the settlement will not be approved.

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***Class Action Suits*** In December 2004 and January 2005, the Company and certain of its current and former officers and directors were named as defendants in several complaints seeking monetary damages filed on behalf of all persons who purchased the Company's common stock during a specified class period. These suits were filed in the U.S. District Court of New Jersey (New Jersey cases) and the U.S. District Court for the Central District of California (California cases), alleging that the defendants violated the Securities Exchange Act of 1934, as amended, by allegedly disseminating materially false and misleading statements and/or concealing material adverse facts. The California cases were consolidated with the New Jersey cases so that all of the class action suits, now known as *Witriol v. Conexant, et al. (Witriol)*, are being heard in the U.S. District Court of New Jersey by the same judge. The defendants believe these charges are without merit and intend to vigorously defend the litigation. On September 1, 2005, the defendants filed their motion to dismiss the case. On November 23, 2005, the court granted the plaintiffs motion to file a second amended complaint, which was filed on December 5, 2005. The defendants filed an amended motion to dismiss the case on February 6, 2006. Plaintiffs filed their opposition on April 24, 2006, and defendants reply was filed on June 14, 2006. On December 4, 2006, the court dismissed the second amended complaint. Two of the three claims were dismissed with prejudice, while the third claim was dismissed without prejudice. On January 10, 2007, the parties filed a stipulation and tolling agreement with the court stating that plaintiffs will not file an appeal of the ruling dismissing two claims with prejudice and the defendants agreed to give plaintiffs' counsel until March 16, 2007 to file an amended complaint with respect to the third claim. On April 9, 2007, the Company and the named plaintiff agreed to settle the case as to all defendants for \$90,000, to be paid by the Company within 30 days of the execution of a written agreement.

In addition, in February 2005, the Company and certain of its current and former officers and the Company's Employee Benefits Plan Committee were named as defendants in *Graden v. Conexant, et al.*, a lawsuit filed on behalf of all persons who were participants in the Company's 401(k) Plan (Plan) during a specified class period. This suit was filed in the U.S. District Court of New Jersey and alleges that the defendants breached their fiduciary duties under the Employee Retirement Income Security Act, as amended, to the Plan and the participants in the Plan. The plaintiff filed an amended complaint on August 11, 2005. On October 12, 2005, the defendants filed a motion to dismiss this case. The plaintiff responded to the motion to dismiss on December 30, 2005, and the defendants' reply was filed on February 17, 2006. On March 31, 2006, the judge dismissed this case and ordered it closed. Plaintiff filed a notice of appeal on April 17, 2006. As of the end of October 2006, the appellate issues had been fully briefed by the parties. The appellate argument was held on April 19, 2007.

***Shareholder Derivative Suits*** In January 2005, the Company and certain of its current and former directors and officers were named as defendants in purported shareholder derivative actions seeking monetary damages (now consolidated) in the California Superior Court for the County of Orange, alleging that the defendants breached their fiduciary duties, abused control, mismanaged the Company, wasted corporate assets and unjustly enriched themselves. A similar lawsuit was filed in the U.S. District Court of New Jersey in May 2005. On July 28, 2005, the California court approved a stay of the actions filed in California pending the outcome of the motion to dismiss in the *Witriol* case. The Company has negotiated a similar stay agreement with the plaintiffs in the New Jersey case, which has also been approved by the New Jersey court. Pursuant to the stay agreements, in the event that the parties in the *Witriol* case engage in any negotiations, plaintiffs' counsel in the derivative cases will be kept informed. The defendants believe the charges in these cases are without merit and intend to vigorously defend the litigation. On February 2, 2007, the court ordered a dismissal of the New Jersey case after the parties had filed a stipulation to dismiss. The Company is informed that plaintiffs have filed papers supporting voluntary dismissal of the California derivative suit; however, the Company has not yet been served with these papers.

**Guarantees and Indemnifications**

The Company has made guarantees and indemnities, under which it may be required to make payments to a guaranteed or indemnified party, in relation to certain transactions. In connection with the Company's spin-off from Rockwell International Corporation, the Company assumed responsibility for all contingent liabilities and then-current

and future litigation (including environmental and intellectual property proceedings) against Rockwell or its subsidiaries in respect of the operations of the semiconductor systems business of Rockwell. In connection with the Company's contribution of certain of its manufacturing operations to Jazz Semiconductor, the Company agreed to indemnify Jazz Semiconductor 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

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connection with certain facility leases, the Company has indemnified its lessors for certain claims arising from the facility or the lease. The Company indemnifies its directors and officers to the maximum extent permitted under the laws of the State of Delaware.

The durations of the Company's guarantees and indemnities vary, and in many cases are indefinite. The guarantees and indemnities to customers in connection with product sales generally are subject to limits based upon the amount of the related product sales. The majority of other guarantees and indemnities do not provide for any limitation of the maximum potential future payments the Company could be obligated to make. The Company has not recorded any liability for these guarantees and indemnities in the accompanying condensed consolidated balance sheets. Product warranty costs are not significant.

**Other**

**Tax Matter** In the three months ended March 30, 2007, the Company received a letter from a foreign jurisdiction proposing certain tax and subsidy assessments related to an acquired foreign subsidiary. The proposed assessments cover both pre- and post-acquisition periods. The Company has been contractually indemnified for any assessments related to the pre-acquisition period, and management does not believe any assessments related to the post-acquisition period will be material.

**Environmental Remediation** The Company has been designated as a potentially responsible party and is engaged in groundwater remediation under a previously approved Consent Decree 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, which has been settled pursuant to a Consent Decree entered into with the Environmental Protection Agency in August 2006. 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 \$1.4 million and has an accrual for these costs in the accompanying condensed consolidated balance sheet at March 30, 2007.

**Capital Investments** In connection with certain non-marketable equity investments, with carrying values totaling \$7.3 million, the Company may be required to invest up to an additional \$3.6 million as of March 30, 2007. These additional investments are subject to capital calls, and a decision by the Company not to participate could result in an impairment of the existing investments.

**5. Shareholders' Equity**

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

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

**Stock Option Plans**

The Company has stock option plans and long-term incentive plans under which employees and directors may be granted options to purchase shares of the Company's common stock. As of March 30, 2007, approximately 63.6 million shares of the Company's common stock are available for grant under the stock option and long-term incentive plans. Stock options are generally granted with exercise prices of not less than the fair market value at



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grant date, generally vest over four years and expire eight or ten years after the grant date. The Company settles stock option exercises with newly issued shares of common stock. The Company has also assumed stock option plans in connection with business combinations.

A summary of stock option activity is as follows (shares in thousands):

	<b>Shares</b>	<b>Weighted Average Exercise Price</b>
Outstanding, September 29, 2006	103,782	\$ 2.65
Granted	1,633	2.02
Exercised	(3,080)	1.42
Canceled	(10,303)	3.41
Outstanding, March 30, 2007	92,032	2.60
Exercisable, March 30, 2007	67,032	2.80

At March 30, 2007, of the 92.0 million stock options outstanding, approximately 69.3 million options were held by current employees and directors of the Company, and approximately 22.7 million options were held by employees of Rockwell, a former Rockwell business, or a former business of the Company (i.e., Mindspeed, Skyworks, Jazz Semiconductor) who remain employed by one of these businesses. At March 30, 2007, the options outstanding had an aggregate intrinsic value of \$5.6 million and a weighted-average remaining contractual term of 4.3 years. At March 30, 2007, the options exercisable had an aggregate intrinsic value of \$3.5 million and a weighted-average remaining contractual term of 3.4 years.

The weighted average grant-date fair value of options granted during the six months ended March 30, 2007 was \$0.93 per share. The total intrinsic value of options exercised during the six months ended March 30, 2007 was \$2.0 million. The total cash received from employees as a result of stock option exercises was \$4.4 million for the six months ended March 30, 2007.

At March 30, 2007, the total unrecognized fair value compensation cost related to unvested stock options and employee stock purchase plan awards was \$23.5 million, which is expected to be recognized over a remaining weighted average period of approximately 2.5 years.

**Directors Stock Plan**

The Company has a Directors Stock Plan (DSP) which provides for each non-employee director to receive specified levels of stock option grants upon election to the Board of Directors and periodically thereafter. Under the DSP, each non-employee director may elect to receive all or a portion of the cash retainer to which the director is entitled through the issuance of common stock. During the six months ended March 30, 2007, 80,000 stock options were granted under the DSP. At March 30, 2007, approximately 0.8 million shares of the Company's common stock are available for grant under the DSP.

**Employee Stock Purchase Plan**

The Company has an employee stock purchase plan (ESPP) which allows eligible employees to purchase shares of the Company's common stock at six-month intervals during an offering period at 85% of the lower of the fair market value on the first day of the offering period or on the purchase date. Under the ESPP, employees may authorize the Company to withhold up to 15% of their compensation for each pay period to purchase shares under the plan, subject to certain limitations, and employees are limited to the purchase of 2,000 shares per offering period. Offering periods

generally commence on the first trading day of February and August of each year and are generally 6 months in duration, but may be terminated earlier under certain circumstances. During the six months ended March 30, 2007, the Company issued approximately 1.9 million shares of common stock under the ESPP for total proceeds of \$2.8 million. At March 30, 2007, approximately 21.6 million shares of the Company's common stock are reserved for future issuance under the ESPP, of which 15.0 million shares will become available in 2.5 million share annual increases, subject to the Board of Directors selecting a lower amount.

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**Performance Share Plan**

The Company has a Performance Share Plan under which it has reserved 4.0 million shares for issuance. On November 15, 2006, the Company issued performance shares at a fair value of \$2.29 per share to an executive in satisfaction of his fiscal 2006 performance share award granted under his employment agreement. The total fair value of the award was \$0.6 million and was paid with 149,187 shares of common stock and cash.

At March 30, 2007, approximately 2.2 million shares of the Company's common stock are available for issuance under this plan, excluding approximately 0.9 million shares reserved for issuance under existing performance awards.

**6. Comprehensive Income (Loss)**

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

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>March 30, 2007</b>	<b>March 31, 2006</b>	<b>March 30, 2007</b>	<b>March 31, 2006</b>
Net loss	\$ (133,446)	\$ (10,132)	\$ (132,470)	\$ (34,403)
Other comprehensive income (loss):				
Currency translation adjustments	3,523	194	4,504	(707)
Unrealized gains (losses) on marketable securities	(5,052)	10,676	6,744	(1,291)
Unrealized gains on foreign currency forward hedge contracts	123		372	
Minimum pension liability adjustments	55	79	109	152
Other comprehensive income (loss)	(1,351)	10,949	11,729	(1,846)
Comprehensive income (loss)	\$ (134,797)	\$ 817	\$ (120,741)	\$ (36,249)

Included in unrealized gains (losses) on marketable securities for the three and six months ended March 30, 2007 is a \$5.8 million unrealized gain relating to the sale of Jazz Semiconductor to Acquicor Technology Inc. (now Jazz Technologies). This gain has been deferred as a result of the Company's on-going investment in Jazz Technologies. See Note 9 for further discussion of the sale of Jazz Semiconductor.

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

	<b>March 30, 2007</b>	<b>September 29, 2006</b>
Currency translation adjustments	\$ 708	\$ (3,796)
Unrealized gains (losses) on marketable securities	4,889	(1,855)
Unrealized gains on foreign currency forward hedge contracts	552	180
Minimum pension liability adjustments	(6,516)	(6,625)
Accumulated other comprehensive income (loss)	\$ (367)	\$ (12,096)



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**7. Special Charges**

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

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>March</b>	<b>March</b>	<b>March</b>	<b>March</b>
	<b>30,</b>	<b>31,</b>	<b>30,</b>	<b>31,</b>
	<b>2007</b>	<b>2006</b>	<b>2007</b>	<b>2006</b>
Asset impairments	\$ 155,000	\$	\$ 155,000	\$ 85
Restructuring charges (credits)	3,499	(1,146)	6,397	(216)
Litigation charges	90	40,000	90	40,000
Other special charges (credits)	1,532		1,532	(100)
	\$ 160,121	\$ 38,854	\$ 163,019	\$ 39,769

**Asset Impairments**

Asset impairments for the three and six months ended March 30, 2007 include non-cash goodwill and intangible asset impairment charges of \$135.0 million and \$20.0 million, respectively, related to the Company's Embedded Wireless Networking business. See Note 3 for further information regarding these impairment charges.

**Restructuring Charges**

The Company has implemented a number of cost reduction initiatives since late fiscal 2001 to improve its operating cost structure. These cost reduction initiatives have 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 costs associated with the employees and facilities of GlobespanVirata, Inc., are included in special charges in the Company's consolidated statements of operations. The costs that related to the employees and facilities of GlobespanVirata have been recorded as acquired liabilities in the merger and included as part of the purchase price allocation. In May 2004, the GlobespanVirata subsidiary was renamed Conexant, Inc.

*Fiscal 2007 Restructuring Actions* In November 2006, the Company announced a facility closure and workforce reductions and announced further workforce reductions in January 2007. In total, the Company notified approximately 115 employees of their involuntary termination. During the six months ended March 30, 2007, the Company recorded total charges of \$5.2 million based on the estimates of the cost of severance benefits for the affected employees and the estimated relocation benefits for those employees who have been offered and have commenced the relocation process. Costs associated with the facility closure will be recorded when the facility is vacated.

Activity and liability balances recorded as part of the Fiscal 2007 Restructuring Actions during the six months ended March 30, 2007 were as follows (in thousands):

	<b>Workforce Reductions</b>
Charged to costs and expenses	\$ 2,027
Cash payments	(214)
Restructuring balance, December 29, 2006	1,813
Charged to costs and expenses	3,218
Cash payments	(1,276)
Restructuring balance, March 30, 2007	\$ 3,755

*Fiscal 2006 Restructuring Actions* In April 2006 and November 2005, the Company announced facility closures and workforce reductions. In total, the Company notified approximately 130 employees of their involuntary termination.

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Activity and liability balances recorded as part of the Fiscal 2006 Restructuring Actions during the six months ended March 30, 2007 were as follows (in thousands):

	<b>Workforce Reductions</b>	<b>Facility and Other</b>	<b>Total</b>
Restructuring balance, September 29, 2006	\$ 1,216	\$ 392	\$ 1,608
Charged to costs and expenses	533	5	538
Cash payments	(951)	(48)	(999)
Restructuring balance, December 29, 2006	798	349	1,147
Charged (credited) to costs and expenses	(200)	45	(155)
Cash payments	(191)	(129)	(320)
Restructuring balance, March 30, 2007	\$ 407		