

MINDSPEED TECHNOLOGIES, INC

Form 10-Q

August 09, 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 June 30, 2005\***

**OR**

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

**Commission file number: 000-50499**

**MINDSPEED TECHNOLOGIES, INC.**

(Exact name of registrant as specified in its charter)

**Delaware**

(State of incorporation)

**01-0616769**

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

**4000 MacArthur Boulevard, East Tower**

**Newport Beach, California 92660-3095**

(Address of principal executive offices) (Zip code)

**(949) 579-3000**

(Registrant's telephone number, including area code)

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

Yes  No

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

Yes  No

Number of shares of registrant's common stock outstanding as of July 29, 2005 was 103,587,669.

\* For presentation purposes of this Form 10-Q, references made to the June 30, 2005 period relate to the actual fiscal 2005 third quarter ended July 1, 2005.

**Table of Contents**

**FORWARD-LOOKING STATEMENTS**

This Quarterly Report on Form 10-Q contains statements relating to Mindspeed Technologies, 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. All statements included in this Quarterly Report on Form 10-Q, other than those that are purely historical, are forward-looking statements. Words such as expect, believe, anticipate, outlook, could, target, project, intend, plan, seek, estimate, should, may, assume and continue, such words and similar expressions, also identify forward-looking statements. Forward-looking statements in this Quarterly Report on Form 10-Q include, without limitation:

discussions of the growth prospects for the network infrastructure equipment and communications semiconductors markets;

the focus of our research and development spending on certain products and our expectation of the growth prospects for those products;

our ability to achieve revenue growth and profitability, or to achieve positive cash flows from operations, and the expected period through which we will continue to incur significant losses and negative cash flows;

the sufficiency of our existing sources of liquidity and expected sources of cash to fund our operations, research and development efforts, anticipated capital expenditures, working capital and other financing requirements for the next twelve months;

the circumstances under which we may need to seek additional financing, our ability to obtain any such financing and any consideration of acquisition opportunities;

discussions of our restructuring plans, including expected workforce reductions and facilities closures and the timing and amount of payments to complete the actions, the source of funds for such payments, the impact on our liquidity and the resulting decreases in our research and development and selling, general and administrative expenses;

our plans relating to our use of stock-based compensation, the effectiveness of our incentive compensation programs and the expected amounts of stock-based compensation expense in future periods;

the amount and timing of future payments under contractual obligations; and

the impact of recent accounting pronouncements.

Our expectations, beliefs, anticipations, objectives, intentions, plans and strategies regarding the future are not guarantees of future performance and are subject to risks and uncertainties that could cause actual results, and actual events that occur, to differ materially from results contemplated by the forward-looking statement. These risks and uncertainties include, but are not limited to:

market demand for our new and existing products and our ability to increase our revenues;

our ability to maintain operating expenses within anticipated levels;

our ability to reduce our cash consumption;

availability and terms of capital needed for our business;

the ability to attract and retain qualified personnel;

successful development and introduction of new products;  
obtaining design wins and developing revenues from them;  
pricing pressures and other competitive factors;  
order and shipment uncertainty;  
fluctuations in manufacturing yields;  
product defects; and

intellectual property infringement claims by others and the ability to protect our intellectual property.

The forward-looking statements in this Quarterly Report on Form 10-Q are subject to additional risks and uncertainties, including those set forth herein under the heading "Certain Business Risks" and those detailed from time to time in our other filings with the Securities and Exchange Commission. These forward-looking statements are made only as of the date hereof and, except as required by law, we undertake no obligation to update or revise any of them, whether as a result of new information, future events or otherwise.

Mindspeed® and Mindspeed Technologies® are registered trademarks of Mindspeed Technologies, Inc. Other brands, names and trademarks contained in this report are the property of their respective owners.

**Table of Contents**

**MINDSPEED TECHNOLOGIES, INC.  
INDEX**

|  | <b>PAGE</b> |
|--|-------------|
| <b><u>PART I. FINANCIAL INFORMATION</u></b>  |             |
| <b><u>Item 1. Financial Statements (unaudited):</u></b>  |             |
| <u>Consolidated Condensed Balance Sheets June 30, 2005 and September 30, 2004</u>                                | 4           |
| <u>Consolidated Condensed Statements of Operations Three Months and Nine Months Ended June 30, 2005 and 2004</u> | 5           |
| <u>Consolidated Condensed Statements of Cash Flows Nine Months Ended June 30, 2005 and 2004</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>             | 15          |
| <u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>  | 35          |
| <u>Item 4. Controls and Procedures</u>   | 35          |
| <b><u>PART II. OTHER INFORMATION</u></b>   |             |
| <u>Item 5. Other Information</u>   | 36          |
| <u>Item 6. Exhibits</u>  | 37          |
| <u>Signature</u>   | 38          |
| <u>EXHIBIT 10.1</u>  |             |
| <u>EXHIBIT 10.2</u>  |             |
| <u>EXHIBIT 10.3</u>  |             |
| <u>EXHIBIT 10.4</u>  |             |
| <u>EXHIBIT 10.5</u>  |             |
| <u>EXHIBIT 10.6</u>  |             |
| <u>EXHIBIT 10.7</u>  |             |
| <u>EXHIBIT 10.8</u>  |             |
| <u>EXHIBIT 10.9</u>  |             |
| <u>EXHIBIT 10.10</u>   |             |
| <u>EXHIBIT 12.1</u>  |             |
| <u>EXHIBIT 31.1</u>  |             |
| <u>EXHIBIT 31.2</u>  |             |
| <u>EXHIBIT 32.1</u>  |             |
| <u>EXHIBIT 32.2</u>  |             |

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

|  | <b>June 30,<br/>2005</b> | <b>September 30,<br/>2004</b> |
|--|--------------------------|-------------------------------|
| <b>ASSETS</b>  |                          |                               |
| <b>Current Assets</b>  |                          |                               |
| Cash and cash equivalents  | \$ 20,862                | \$ 43,638                     |
| Marketable securities  | 42,473                   |                               |
| Receivables, net of allowance of \$471 and \$627 at June 30, 2005 and September 30, 2004, respectively   | 14,769                   | 19,618                        |
| Inventories, net   | 10,061                   | 11,986                        |
| Other current assets   | 5,519                    | 6,114                         |
| Total current assets   | 93,684                   | 81,356                        |
| Property, plant and equipment, net   | 16,421                   | 20,979                        |
| Intangible assets, net   |                          | 20,385                        |
| Other assets   | 4,243                    | 3,580                         |
| Total assets   | \$ 114,348               | \$ 126,300                    |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b>   |                          |                               |
| <b>Current Liabilities</b>   |                          |                               |
| Accounts payable   | \$ 12,327                | \$ 13,112                     |
| Deferred revenue   | 3,358                    | 3,471                         |
| Accrued compensation and benefits  | 8,004                    | 9,282                         |
| Restructuring  | 3,395                    | 2,823                         |
| Other current liabilities  | 3,071                    | 3,586                         |
| Total current liabilities  | 30,155                   | 32,274                        |
| Convertible senior notes   | 44,121                   |                               |
| Other liabilities  | 2,788                    | 3,099                         |
| Total liabilities  | 77,064                   | 35,373                        |
| Commitments and contingencies  |                          |                               |
| <b>Stockholders Equity</b>   |                          |                               |
| Preferred and junior preferred stock   |                          |                               |
| Common stock, \$0.01 par value: 500,000 shares authorized; 103,201 and 100,619 shares issued at June 30, 2005 and September 30, 2004, respectively | 1,032                    | 1,006                         |
| Additional paid-in capital   | 236,679                  | 231,577                       |

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|  |            |            |
|--|------------|------------|
| Accumulated deficit                        | (183,764)  | (125,423)  |
| Accumulated other comprehensive loss       | (16,097)   | (16,024)   |
| Unearned compensation                      | (566)      | (209)      |
| Total stockholders' equity                 | 37,284     | 90,927     |
| Total liabilities and stockholders' equity | \$ 114,348 | \$ 126,300 |

See accompanying notes to consolidated condensed financial statements.

4

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**Table of Contents**

**MINDSPEED TECHNOLOGIES, INC.**  
**Consolidated Condensed Statements of Operations**  
**(unaudited, in thousands, except per share amounts)**

|   | Three months ended |             | Nine months ended |             |
|---|--------------------|-------------|-------------------|-------------|
|   | June 30,           |             | June 30,          |             |
|   | 2005               | 2004        | 2005              | 2004        |
| Net revenues  | \$ 27,738          | \$ 35,360   | \$ 80,698         | \$ 92,856   |
| Cost of goods sold  | 8,207              | 10,155      | 24,505            | 26,182      |
| Gross margin  | 19,531             | 25,205      | 56,193            | 66,674      |
| Operating expenses:   |                    |             |                   |             |
| Research and development  | 16,748             | 19,095      | 54,965            | 59,639      |
| Selling, general and administrative                             | 10,797             | 12,744      | 31,889            | 35,617      |
| Amortization of intangible assets                               | 824                | 12,609      | 20,481            | 37,716      |
| Special charges   | (125)              |             | 5,856             | 387         |
| Total operating expenses  | 28,244             | 44,448      | 113,191           | 133,359     |
| Operating loss  | (8,713)            | (19,243)    | (56,998)          | (66,685)    |
| Other income (expense), net                                     | (193)              | (82)        | (447)             | 267         |
| Loss before income taxes  | (8,906)            | (19,325)    | (57,445)          | (66,418)    |
| Provision for income taxes                                      | 561                | 816         | 896               | 1,289       |
| Net loss  | \$ (9,467)         | \$ (20,141) | \$ (58,341)       | \$ (67,707) |
| Net loss per share, basic and diluted                           | \$ (0.09)          | \$ (0.20)   | \$ (0.57)         | \$ (0.69)   |
| Weighted-average number of shares used in per share computation | 102,698            | 99,467      | 101,859           | 97,440      |

See accompanying notes to consolidated condensed financial statements.



**Table of Contents**

**MINDSPEED TECHNOLOGIES, INC.**  
**Consolidated Condensed Statements of Cash Flows**  
**(unaudited, in thousands)**

|   | <b>Nine months ended</b> |             |
|---|--------------------------|-------------|
|   | <b>June 30,</b>          |             |
|   | <b>2005</b>              | <b>2004</b> |
| <b>Cash Flows From Operating Activities</b>                                 |                          |             |
| Net loss  | \$(58,341)               | \$(67,707)  |
| Adjustments to reconcile net loss to net cash used in operating activities: |                          |             |
| Depreciation  | 7,072                    | 8,605       |
| Amortization of intangible assets   | 20,481                   | 37,716      |
| Asset impairments   | 604                      |             |
| Inventory provisions  | 977                      | 2,805       |
| Other non-cash items, net   | 728                      | 138         |
| Changes in assets and liabilities:  |                          |             |
| Receivables   | 5,000                    | (6,604)     |
| Inventories   | 948                      | (10,663)    |
| Accounts payable  | (785)                    | 1,092       |
| Deferred revenue  | (113)                    | 1,207       |
| Accrued expenses and other current liabilities                              | 173                      | (1,731)     |
| Other   | 412                      | 1,892       |
| Net cash used in operating activities                                       | (22,844)                 | (33,250)    |
| <b>Cash Flows From Investing Activities</b>                                 |                          |             |
| Capital expenditures  | (3,232)                  | (3,935)     |
| Sales of assets   | 149                      | 54          |
| Purchases of available-for-sale marketable securities                       | (61,725)                 |             |
| Sales of available-for-sale marketable securities                           | 20,950                   |             |
| Purchases of held-to-maturity marketable securities                         | (3,253)                  |             |
| Maturities of held-to-maturity marketable securities                        | 767                      |             |
| Net cash used in investing activities                                       | (46,344)                 | (3,881)     |
| <b>Cash Flows From Financing Activities</b>                                 |                          |             |
| Sale of convertible senior notes  | 43,930                   |             |
| Exercise of stock options and warrants                                      | 2,915                    | 11,827      |
| Deferred financing costs  | (433)                    | (64)        |
| Net cash provided by financing activities                                   | 46,412                   | 11,763      |
| Net decrease in cash and cash equivalents                                   | (22,776)                 | (25,368)    |
| Cash and cash equivalents at beginning of period                            | 43,638                   | 80,121      |
| Cash and cash equivalents at end of period                                  | \$ 20,862                | \$ 54,753   |



**Table of Contents**

**MINDSPEED TECHNOLOGIES, INC.**  
**NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS**  
(unaudited)

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

Mindspeed Technologies, Inc. (Mindspeed or the Company) designs, develops and sells semiconductor networking solutions for communications applications in enterprise, access, metropolitan and wide-area networks. On June 27, 2003, Conexant Systems, Inc. (Conexant) completed the distribution (the Distribution) to Conexant stockholders of all 90,333,445 outstanding shares of common stock of its wholly owned subsidiary, Mindspeed. In the Distribution, each Conexant stockholder received one share of Mindspeed common stock (including an associated preferred share purchase right) for every three shares of Conexant common stock held and cash for any fractional share of Mindspeed common stock. Following the Distribution, Mindspeed began operations as an independent, publicly held company. Prior to the Distribution, Conexant transferred to Mindspeed the assets and liabilities of the Mindspeed business, including the stock of certain subsidiaries, and certain other assets and liabilities which were allocated to Mindspeed under the Distribution Agreement entered into between Conexant and Mindspeed. Also prior to the Distribution, Conexant contributed to Mindspeed cash in an amount such that at the time of the Distribution Mindspeed's cash balance was \$100 million. Mindspeed issued to Conexant a warrant to purchase 30 million shares of Mindspeed common stock at a price of \$3.408 per share, exercisable for a period beginning one year and ending ten years after the Distribution. In connection with the Distribution, Mindspeed and Conexant also entered into a Credit Agreement, an Employee Matters Agreement, a Tax Allocation Agreement, a Transition Services Agreement and a Sublease.

*Basis of Presentation* The consolidated condensed financial statements, prepared in accordance with accounting principles generally accepted in the United States of America, include the accounts of Mindspeed and each of its subsidiaries. All accounts and transactions among Mindspeed and its subsidiaries have been eliminated in consolidation. In the opinion of management, the accompanying consolidated condensed financial statements contain all adjustments, consisting of adjustments of a normal recurring nature and the special charges (Note 6), 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 financial 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 June 30, 2005 and 2004 relate to the actual fiscal 2005 third quarter ended July 1, 2005 and the actual fiscal 2004 third quarter ended July 2, 2004, respectively. References to the periods ended September 30, 2004 relate to the actual fiscal year ended October 1, 2004.

*Recent Accounting Standards* In December 2004, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 123 (revised 2004), Share-Based Payment (SFAS 123R). Under SFAS 123R, the Company will no longer be able to account for share-based compensation transactions using the intrinsic value method of APB 25. Instead, the Company will be required to account for such transactions using a fair-value method and to recognize the fair value of each award over the service period. SEC Release No. 33-8568 makes SFAS 123R effective for fiscal years beginning after June 15, 2005, and SFAS 123R allows for several alternative transition methods. The Company expects to adopt SFAS 123R as of the beginning of the fiscal 2006 first quarter using modified prospective application, which will require that the Company recognize compensation expense for new awards, modified awards and for any awards outstanding at the effective date but vesting after such date. The actual amounts of stock compensation expense the Company recognizes in periods following the adoption of SFAS 123R will depend on a number of factors, including the types of awards made, the specific terms of awards, changes in the market price of the Company's common stock and other factors. Although the Company is currently evaluating the impact of SFAS 123R on its results of operations, the Company expects the adoption of SFAS 123R to materially increase its operating expenses beginning in fiscal 2006. See *Stock-Based Compensation* below.

In November 2004, the FASB issued SFAS No. 151, Inventory Costs, an amendment of Accounting Research Bulletin (ARB) No. 43, Chapter 4. SFAS 151 amends the guidance in ARB No. 43 to clarify that abnormal



Table of Contents

**MINDSPEED TECHNOLOGIES, INC.**  
**NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (continued)**  
(unaudited)

amounts of idle facility expense, freight, handling costs and wasted material (spoilage) should be recognized as current-period charges. In addition, SFAS 151 requires that allocation of fixed production overhead to the costs of conversion be based on the normal capacity of the production facilities. The Company must adopt SFAS 151 as of the beginning of fiscal 2006 and does not expect that the adoption of SFAS 151 will have a material impact on its financial condition or results of operations.

In May 2005, the FASB issued SFAS No. 154, *Accounting Changes and Error Corrections*, which replaces APB Opinion No. 20, *Accounting Changes*, and SFAS No. 3, *Reporting Accounting Changes in Interim Financial Statements*. SFAS No. 154 applies to all voluntary changes in accounting principle and requires retrospective application (a term defined by the statement) to prior periods' financial statements, unless it is impracticable to determine the effect of a change. It also applies to changes required by an accounting pronouncement that does not include specific transition provisions. SFAS 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The Company will adopt SFAS No. 154 as of the beginning of fiscal 2007 and does not expect that the adoption of SFAS 154 will have a material impact on its financial condition or results of operations.

*Stock-Based Compensation* As permitted by Statement of Financial Accounting Standards (SFAS) No. 123, *Accounting for Stock-Based Compensation*, the Company accounts for stock-based compensation under Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations. Under the intrinsic value method required by APB 25, the Company generally recognizes no compensation expense with respect to stock option awards. The following table illustrates the effect on net loss and net loss per share as if compensation expense for all awards of stock-based employee compensation had been determined under the fair value-based method prescribed by SFAS 123 (in thousands, except per share amounts).

|  | <b>Three months ended</b> |             | <b>Nine months ended</b> |             |
|--|---------------------------|-------------|--------------------------|-------------|
|  | <b>June 30,</b>           |             | <b>June 30,</b>          |             |
|  | <b>2005</b>               | <b>2004</b> | <b>2005</b>              | <b>2004</b> |
| Net loss, as reported  | \$ (9,467)                | \$ (20,141) | \$ (58,341)              | \$ (67,707) |
| Stock-based employee compensation expense determined under the fair value method | 1,634                     | 5,292       | 8,706                    | 21,383      |
| Pro forma net loss   | \$ (11,101)               | \$ (25,433) | \$ (67,047)              | \$ (89,090) |
| Net loss per share, basic and diluted:   |                           |             |                          |             |
| As reported  | \$ (0.09)                 | \$ (0.20)   | \$ (0.57)                | \$ (0.69)   |
| Pro forma  | \$ (0.11)                 | \$ (0.26)   | \$ (0.66)                | \$ (0.91)   |

For purposes of the pro forma disclosures, compensation expense includes the estimated fair value of all stock-based compensation awarded to Mindspeed employees, including options to purchase Conexant common stock granted to Mindspeed employees prior to the Distribution. The fair value of each award is amortized to expense over its vesting period. The decrease in stock-based employee compensation expense determined under the fair value method for the nine months ended June 30, 2005 compared to the nine months ended June 30, 2004 reflects the higher fair values of awards made prior to the Distribution and the effect of many of those awards becoming vested. The fair value of stock options granted by Mindspeed under its stock option plans has been estimated as of the date of grant using the Black-Scholes option pricing model.

|  | <b>Nine months ended<br/>June 30,</b> |             |
|--|---------------------------------------|-------------|
|  | <b>2005</b>                           | <b>2004</b> |
| Weighted-average fair value of options granted | \$1.05                                | \$4.73      |
| Weighted-average assumptions:                  |                                       |             |
| Risk-free interest rate                        | 3.9%                                  | 2.5%        |
| Expected volatility                            | 80%                                   | 90%         |
| Dividend yield                                 |                                       |             |
| Expected option life                           | 2.1 years                             | 3.5 years   |

The Company estimates the expected life of each award based on its terms, including vesting provisions. During the nine months ended June 30, 2005, the Company granted a total of 3.0 million options to employees, exercisable at

**Table of Contents**

**MINDSPEED TECHNOLOGIES, INC.**  
**NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (continued)**  
(unaudited)

prices ranging from \$1.19 to \$2.84 per share, and expiring eight years after the grant date. The fiscal 2005 awards include a broad-based grant of options to purchase an aggregate of 2.4 million shares at \$2.28 per share, of which 50% vest six months following the grant date and the remainder vest one year after the grant date. Other stock option awards generally vest ratably over four years.

As required by SFAS 123R, stock compensation expense for fiscal 2006 and thereafter will include the value of new awards, modified awards and any awards outstanding at September 30, 2005 but vesting after that date. Based on all awards of stock-based compensation made through June 30, 2005, the Company expects the amount of such expense, by fiscal year, will be at least \$4.2 million (2006), \$1.8 million (2007) and \$0.5 million (2008). However, the actual amounts of such expense will depend on the quantity and terms of additional awards, forfeitures of outstanding awards and other factors.

*Income Taxes* The provision for income taxes for the nine months ended June 30, 2005 and 2004 principally consists of income taxes incurred by the Company's foreign subsidiaries.

*Supplemental Cash Flow Information* Interest paid for the nine months ended June 30, 2005 was \$767,000; the Company paid no interest for the nine months ended June 30, 2004. Income taxes paid, net of refunds received, for the nine months ended June 30, 2005 and 2004 were \$332,000 and \$194,000, respectively.

## **2. Supplemental Financial Statement Data**

### ***Marketable Securities***

Marketable securities principally consist of auction rate debt securities and auction rate preferred securities with interest at rates that are reset periodically (generally every seven or twenty-eight days). These securities are classified as available-for-sale securities and recorded at fair value in the accompanying balance sheets. Any unrealized gains/losses are included in other comprehensive income, unless a loss is determined to be other than temporary. As of June 30, 2005, the securities have a fair value of approximately \$40.8 million and there are no unrealized gains or losses. The Company classifies available-for-sale securities as current assets in the accompanying balance sheets because the Company has the ability and intent to sell these securities as necessary to meet its liquidity requirements. Marketable securities also include U.S. Treasury securities having an aggregate face amount of approximately \$2.6 million purchased in connection with the sale of \$46.0 million aggregate principal amount of Convertible Senior Notes. These securities, which mature at various dates through November 2006, were pledged to the trustee for the payment of the first four scheduled interest payments on the notes when due. Consequently, these securities are classified as held-to-maturity securities and are recorded at their amortized cost of \$2.5 million (including \$831,000 included in other assets), which approximates fair value.

### ***Inventories***

Inventories consist of the following (in thousands):

|                 | <b>June 30,<br/>2005</b> | <b>September<br/>30,<br/>2004</b> |
|-----------------|--------------------------|-----------------------------------|
| Work-in-process | \$ 4,218                 | \$ 4,585                          |
| Finished goods  | 5,843                    | 7,401                             |
|                 | <b>\$ 10,061</b>         | <b>\$ 11,986</b>                  |

For the nine months ended June 30, 2005 and 2004, our gross margin included a benefit of \$7.2 million and \$6.3 million, respectively, from the sale of inventories that we had written down to a zero cost basis during fiscal 2001.

Table of Contents

**MINDSPEED TECHNOLOGIES, INC.**  
**NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (continued)**  
(unaudited)

**Intangible Assets**

Intangible assets consist of the following (in thousands):

|                         | <b>June 30, 2005</b>   |                                     | <b>September 30, 2004</b> |                                     |
|-------------------------|------------------------|-------------------------------------|---------------------------|-------------------------------------|
|                         | <b>Gross<br/>Asset</b> | <b>Accumulated<br/>Amortization</b> | <b>Gross<br/>Asset</b>    | <b>Accumulated<br/>Amortization</b> |
| Developed technology    | \$228,449              | \$(228,449)                         | \$228,618                 | \$(210,467)                         |
| Customer base           | 28,016                 | (28,016)                            | 28,045                    | (25,916)                            |
| Other intangible assets | 10,764                 | (10,764)                            | 10,786                    | (10,681)                            |
|                         | \$267,229              | \$(267,229)                         | \$267,449                 | \$(247,064)                         |

The changes in the gross amounts of intangible assets as of June 30, 2005, as compared with September 30, 2004, reflect the impact of foreign currency translation adjustments. Intangible assets were amortized over periods averaging approximately five years for each major asset class and extending to various dates through June 2005. As of June 30, 2005, this periodic amortization has reduced the carrying value of intangible assets to zero and no additional amortization expense will be recorded on the Company's existing intangible assets in future periods.

**Comprehensive Loss**

Comprehensive loss is as follows (in thousands):

|  | <b>Three months ended<br/>June 30,</b> |             | <b>Nine months ended<br/>June 30,</b> |             |
|--|--|-------------|---------------------------------------|-------------|
|  | <b>2005</b>                            | <b>2004</b> | <b>2005</b>                           | <b>2004</b> |
| Net loss                                 | \$(9,467)                              | \$(20,141)  | \$(58,341)                            | \$(67,707)  |
| Foreign currency translation adjustments | (143)                                  | (21)        | (73)                                  | 944         |
| Comprehensive loss                       | \$(9,610)                              | \$(20,162)  | \$(58,414)                            | \$(66,763)  |

The balance of accumulated other comprehensive loss at June 30, 2005 and September 30, 2004 consists of accumulated foreign currency translation adjustments.

**Revenues by Product Line**

Revenues by product line are as follows (in thousands):

|                                     | <b>Three months ended<br/>June 30,</b> |             | <b>Nine months ended<br/>June 30,</b> |             |
|-------------------------------------|--|-------------|---------------------------------------|-------------|
|                                     | <b>2005</b>                            | <b>2004</b> | <b>2005</b>                           | <b>2004</b> |
| Multiservice access DSP products    | \$ 8,974                               | \$ 9,472    | \$24,188                              | \$21,553    |
| High-performance analog products    | 6,854                                  | 9,319       | 20,028                                | 19,191      |
| T/E carrier products                | 7,195                                  | 11,289      | 21,737                                | 33,977      |
| ATM/MPLS network processor products | 4,715                                  | 5,255       | 14,745                                | 17,842      |
| Other                               |  | 25          |                                       | 293         |
|                                     | \$27,738                               | \$35,360    | \$80,698                              | \$92,856    |

**Revenues by Geographic Area**

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



|                                | <b>Three months ended</b> |             | <b>Nine months ended</b> |             |
|--------------------------------|---------------------------|-------------|--------------------------|-------------|
|                                | <b>June 30,</b>           |             | <b>June 30,</b>          |             |
|                                | <b>2005</b>               | <b>2004</b> | <b>2005</b>              | <b>2004</b> |
| Americas                       | \$ 8,314                  | \$11,451    | \$29,704                 | \$36,241    |
| Asia-Pacific                   | 16,025                    | 18,043      | 41,124                   | 42,334      |
| Europe, Middle East and Africa | 3,399                     | 5,866       | 9,870                    | 14,281      |
|                                | \$27,738                  | \$35,360    | \$80,698                 | \$92,856    |

The Company believes a substantial portion of the products sold to original equipment manufacturers (OEMs) and third-party manufacturing service providers in the Asia-Pacific region are ultimately shipped to end-markets in the Americas and Europe.

**Table of Contents**

**MINDSPEED TECHNOLOGIES, INC.**  
**NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (continued)**  
(unaudited)

The following direct customers accounted for 10% or more of net revenues:

|            | <b>Nine months ended</b> |             |
|------------|--------------------------|-------------|
|            | <b>June 30,</b>          |             |
|            | <b>2005</b>              | <b>2004</b> |
| Customer A | 15%                      | 16%         |
| Customer B | 16%                      | 6%          |
| Customer C | 14%                      | 8%          |
| Customer D | 12%                      | 9%          |
| Customer E |                          | 13%         |

**3. Convertible Senior Notes**

In December 2004, the Company sold \$46.0 million aggregate principal amount of Convertible Senior Notes due 2009 for net proceeds (after discounts and commissions) of approximately \$43.9 million. The notes are senior unsecured obligations of the Company, ranking equal in right of payment with all future unsecured indebtedness. The notes bear interest at a rate of 3.75%, payable semiannually in arrears each May 18 and November 18. The Company used approximately \$3.3 million of the proceeds to purchase U.S. government securities that have been pledged to the trustee for the payment of the first four scheduled interest payments on the notes when due.

The notes are convertible, at the option of the holder, at any time prior to maturity into shares of the Company's common stock. Upon conversion, the Company may, at its option, elect to deliver cash in lieu of shares of its common stock or a combination of cash and shares of common stock. Effective May 13, 2005, the conversion price of the notes was adjusted to \$2.31 per share of common stock, which is equal to a conversion rate of approximately 432.9004 shares of common stock per \$1,000 principal amount of notes. Prior to this adjustment, the conversion price applicable to the notes was \$2.81 per share of common stock, which was equal to approximately 355.8719 shares of common stock per \$1,000 principal amount of notes. The adjustment was made pursuant to the terms of the indenture governing the notes. The conversion price is subject to further adjustment under the terms of the indenture to reflect stock dividends, stock splits, issuances of rights to purchase shares of common stock and certain other events.

If the Company undergoes certain fundamental changes (as defined in the indenture), holders of notes may require the Company to repurchase some or all of their notes at 100% of the principal amount plus accrued and unpaid interest. If, upon notice of certain events constituting a fundamental change, holders of the notes elect to convert the notes, the Company will be required to increase the number of shares issuable upon conversion by up to 78.9 shares per \$1,000 principal amount of notes. The number of additional shares, if any, will be determined by the table set forth in the indenture governing the notes. In the event of a non-stock change of control constituting a public acquirer change of control (as defined in the indenture), the Company may, in lieu of issuing additional shares or making an additional cash payment upon conversion as required by the indenture, elect to adjust the conversion price and the related conversion obligation such that the noteholders will be entitled to convert their notes into a number of shares of public acquirer common stock.

For financial accounting purposes, the Company's contingent obligation to issue additional shares or make an additional cash payment upon conversion following a fundamental change is an embedded derivative. As of June 30, 2005, the estimated fair value of the Company's liability under the fundamental change adjustment was not significant. In connection with the sale of the notes, the Company granted the purchasers certain registration rights. The Company's Form S-3 registration statement covering the resale of the notes and the sale of shares issuable upon conversion of the notes was declared effective by the Securities and Exchange Commission on April 6, 2005. Upon completion of the sale of the notes, the \$50 million Credit Agreement with Conexant was terminated. The Company had made no borrowings under the credit facility, and no portion of the related warrant is, or will become, exercisable.



Table of Contents

**MINDSPEED TECHNOLOGIES, INC.**  
**NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (continued)**  
(unaudited)

Interest expense for the nine months ended June 30, 2005 was \$1.2 million.

**4. Stock Warrants**

During the nine months ended June 30, 2005, the Company issued 478,405 shares of its common stock upon the exercise of all remaining warrants held by Jazz Semiconductor, Inc. for aggregate proceeds of \$1.2 million.

As of June 30, 2005, outstanding warrants consist of a warrant to purchase 30 million shares of Mindspeed common stock at a price of \$3.408 per share, exercisable through June 27, 2013, held by Conexant.

**5. Commitments and Contingencies**

Various lawsuits, claims and proceedings have been or may be instituted or asserted against the Company, including those pertaining to product liability, intellectual property, environmental, safety and health and employment matters. In connection with the Distribution, Mindspeed assumed responsibility for all contingent liabilities and then-current and future litigation against Conexant or its subsidiaries to the extent such matters relate to the Mindspeed business. 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, management of the Company believes the disposition of such matters will not have a material adverse effect on the financial condition or results of operations of the Company.

The Company has 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 Distribution, the Company assumed responsibility for all contingent liabilities and then-current and future litigation against Conexant or its subsidiaries related to Mindspeed. The Company may also be responsible for certain federal income tax liabilities under the Tax Allocation Agreement between Mindspeed and Conexant, which provides that the Company will be responsible for certain taxes imposed on Mindspeed, Conexant or Conexant stockholders. 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, officers, employees and agents to the maximum extent permitted under the laws of the State of Delaware. The duration of the guarantees and indemnities varies, and in many 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 condensed balance sheets. Product warranty costs have not been significant to date.

**6. Special Charges**

Special charges consist of the following (in thousands):

|                       | <b>Three months ended</b> |             | <b>Nine months ended</b> |             |
|-----------------------|---------------------------|-------------|--------------------------|-------------|
|                       | <b>June 30,</b>           |             | <b>June 30,</b>          |             |
|                       | <b>2005</b>               | <b>2004</b> | <b>2005</b>              | <b>2004</b> |
| Asset impairments     | \$                        | \$          | \$ 604                   | \$          |
| Restructuring charges | (125)                     |             | 5,252                    | 387         |
|                       | \$(125)                   | \$          | \$5,856                  | \$387       |

*Asset Impairments*

During the first nine months of fiscal 2005, the Company recorded asset impairment charges totaling \$604,000 related to property and equipment that it determined to abandon or scrap.



**Table of Contents**

**MINDSPEED TECHNOLOGIES, INC.**  
**NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (continued)**  
(unaudited)

*Restructuring Charges*

*Mindspeed 2004 Restructuring Plan* In October 2004, the Company announced a restructuring plan intended to reduce its operating expenses while focusing its research and development investment in key high-growth markets, including voice-over-Internet protocol (VoIP) and high-performance analog applications. The expense reduction actions under the restructuring plan include workforce reductions and the closure of a design center in Herzlia, Israel. Approximately 80% of the anticipated expense reductions is expected to come from the termination of research and development programs which the Company believes have a longer return-on-investment timeframe or that address slower growth markets. The affected research and development programs are principally the Company's asynchronous transfer mode (ATM)/multi-protocol label switching (MPLS) network processor products and, to a lesser extent, its T/E carrier transmission products. The remainder of the expected cost savings is expected to come from the selling, general and administrative functions. Through June 30, 2005, we had completed the majority of these actions, reducing our workforce by approximately 80 employees. The remaining cost reduction actions under this restructuring plan consist of the closure of our Lisle, Illinois design center and related workforce reductions. The Company expects to complete these actions by the end of fiscal 2005, bringing the total reduction in its workforce to approximately 90 employees.

In connection with these actions, the Company recorded restructuring charges of approximately \$5.3 million during the first nine months of fiscal 2005. The restructuring charges included an aggregate of \$2.8 million for severance benefits payable to the affected employees and approximately \$2.5 million related to contractual obligations for the purchase of design tools and other services in excess of anticipated requirements. The Company expects to record additional fiscal 2005 restructuring charges totaling approximately \$0.4 million to complete these cost reduction actions. The Company expects to pay the majority of the restructuring costs in cash during fiscal 2005.

Activity and liability balances related to the Mindspeed 2004 restructuring plan through June 30, 2005 are as follows (in thousands):

|                                      | <b>Workforce<br/>Reductions</b> | <b>Facility<br/>and Other</b> | <b>Total</b> |
|--------------------------------------|---------------------------------|-------------------------------|--------------|
| Charged to costs and expenses        | \$ 2,824                        | \$ 2,517                      | \$ 5,341     |
| Cash payments                        | (2,200)                         | (383)                         | (2,583)      |
| Restructuring balance, June 30, 2005 | \$ 624                          | \$ 2,134                      | \$ 2,758     |

*Other Restructuring Plans* In fiscal 2001, 2002 and 2003, the Company implemented a number of cost reduction initiatives to improve its operating cost structure. The cost reduction initiatives included workforce reductions, significant reductions in capital spending, the consolidation of certain facilities and salary reductions for the senior management team. During the nine months ended June 30, 2005, the Company reversed \$89,000 of previously accrued costs upon the resolution of liabilities for certain contractual obligations. Cash payments under these restructuring plans were \$1.6 million for the nine months ended June 30, 2005 and, as of June 30, 2005, the Company's remaining liabilities under these restructuring plans totaled \$3.1 million.

As of June 30, 2005, the Company has a remaining accrued restructuring balance totaling \$5.8 million (including \$2.4 million classified as a long-term liability), principally representing obligations under non-cancelable leases and other contractual commitments. The Company expects to pay these obligations over their respective terms, which expire at various dates through fiscal 2008. The payments will be funded from available cash balances and funds from product sales and are not expected to impact significantly the Company's liquidity.

**7. Related Party Transactions**

Mindspeed leases its headquarters and principal design center in Newport Beach, California from Conexant. In March 2005, the Company and Conexant entered into an Amended and Restated Sublease. As amended, the Sublease

has an initial term extending through June 2008 and the Company may, at its option, extend the Sublease for an additional two-year term. Rent payable under the amended Sublease will initially be approximately \$3.9 million annually, subject to annual increases of 3%, plus a prorated portion of operating expenses associated with the leased property. The Company's minimum future obligation under the amended Sublease is estimated at

**Table of Contents**

**MINDSPEED TECHNOLOGIES, INC.**  
**NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (continued)**  
(unaudited)

approximately \$6.1 million annually (a total of \$18.7 million over the remainder of the initial lease term), but actual costs will vary based upon Conexant's actual costs. In addition, each year the Company may elect to purchase certain services from Conexant based on a prorated portion of Conexant's actual costs.

Following the Distribution, Mindspeed and Conexant each provided certain services to the other under the Transition Services Agreement. For the nine months ended June 30, 2004, the aggregate cost of such services under the Transition Services Agreement and rent under the Sublease was \$3.6 million. For the nine months ended June 30, 2005, rent expense under the Sublease totaled \$3.1 million and services under the Transition Services Agreement were insignificant.

Product sales to Conexant were \$1.2 million and \$713,000 for the nine months ended June 30, 2005 and 2004, respectively.



**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 our fiscal year ended September 30, 2004.

**Overview**

We design, develop and sell semiconductor networking solutions for communications applications in enterprise, access, metropolitan and wide-area networks. Our products, ranging from physical-layer transceivers and framers to higher-layer network processors, are classified into four focused product families: high-performance analog products, multiservice access digital signal processor (DSP) products, T/E carrier products and asynchronous transfer mode (ATM)/multi-protocol label switching (MPLS) network processor products. Our products are sold to original equipment manufacturers (OEMs) for use in a variety of network infrastructure equipment, including voice and media gateways, high-speed routers, switches, access multiplexers, cross-connect systems, add-drop multiplexers, digital loop carrier equipment and Internet protocol (IP) private branch exchanges (PBXs). Service providers use this equipment for the processing, transmission and switching of high-speed voice and data traffic, including advanced services such as voice-over-Internet protocol (VoIP), within different segments of the communications network. Our customers include Alcatel Data Networks, S.A., Cisco Systems, Inc., Huawei Technologies Co., Ltd., Nortel Networks, Inc. and Siemens A.G.

We market and sell our semiconductor products and system solutions directly to leading network infrastructure OEMs. We also sell our products indirectly to OEMs through electronic component distributors and third-party electronic manufacturing service providers, who manufacture products incorporating our semiconductor networking solutions for OEMs. Sales to distributors accounted for approximately 53% and 46% of our revenues for fiscal 2004 and the first nine months of fiscal 2005, respectively. For fiscal 2004, distributors Avnet, Inc. and RTI Industries Company Ltd. accounted for 16% and 12% of our net revenues; for the first nine months of fiscal 2005, distributors Avnet and Alltek Technology Corporation and manufacturing service providers Jabil Circuit, Inc. and Sanmina-SCI Corporation accounted for 15%, 14%, 16% and 12%, respectively, of our net revenues. No other direct customer accounted for 10% or more of our net revenues for these periods. Including indirect sales, we believe that Cisco Systems, Inc. accounted for approximately 20% and 23% of our net revenues for fiscal 2004 and the first nine months of fiscal 2005, respectively, and that no other OEM customer accounted for 10% or more of our net revenues for these periods. Sales to customers located outside the United States, primarily in the Asia-Pacific region and Europe, were approximately 68% and 69%, respectively, of our net revenues for fiscal 2004 and the first nine months of fiscal 2005. We believe a substantial portion of the products we sell to OEMs and third-party manufacturing service providers in the Asia-Pacific region are ultimately shipped to end markets in the Americas and Europe.

**Trends and Factors Affecting Our Business**

During the late 1990's and extending into 2000, the semiconductor industry in general, and communications applications in particular, enjoyed unprecedented growth, benefiting from the rapid expansion of the Internet and other communication services worldwide. Beginning in fiscal 2001, we like many of our customers and competitors were adversely impacted by a global economic slowdown and an abrupt decline in demand for many of the end-user products that incorporate our communications semiconductor products. The impact of weakened end-customer demand was compounded by higher than normal levels of equipment and component inventories held by many of our customers. These conditions represented the worst downturn in the history of the semiconductor industry, and the market for communications semiconductor products was impacted more severely than the industry as a whole. During this period, our net revenues decreased from \$579.2 million for fiscal 2000 to \$80.0 million in fiscal 2002.

In response to this severe downturn in the markets for our products, we took a number of actions designed to improve our financial performance, including workforce reductions, significant decreases in capital spending, the consolidation of certain facilities and salary reductions for our senior management team. These actions reduced our

## **Table of Contents**

workforce from approximately 1,500 employees in fiscal 2000 to 547 employees at July 29, 2005. Through these cost reduction actions, we reduced our combined research and development and selling, general and administrative expenses from \$306.2 million in fiscal 2001 to \$126.4 million in fiscal 2004. In October 2004, we announced additional cost reduction actions, as discussed below, designed to reduce our combined quarterly research and development and selling, general and administrative expenses to approximately \$26 million by the fourth quarter of fiscal 2005.

At the same time, we have sought to maximize our return on our research and development spending by focusing our efforts on products for the network infrastructure applications that we believe offer the most attractive near-term growth prospects. In addition, we eliminated research and development spending in product areas that we believe have a longer return-on-investment timeframe or that address slower growth markets. In particular, we ceased research and development efforts directed toward applications such as high-end optical networking. As a result of this process, we closed four design centers and we sold the assets of the NetPlane Systems software business.

Our products are components of network infrastructure equipment. As a result, we rely on network infrastructure OEMs to select our products from among alternative offerings to be designed into their equipment. These design wins are an integral part of the long sales cycle for our products. Our customers generally 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.

In order to achieve profitability, we must achieve substantial revenue growth. Our ability to achieve the necessary revenue growth will depend on increased demand for network infrastructure equipment that incorporates our products, which in turn depends primarily on the level of capital spending by communications service providers and enterprises. We believe the market for network infrastructure equipment in general, and for communications semiconductors in particular, offers attractive long-term growth prospects due to the build-out of telecommunication networks in developing countries and the continued upgrading and expansion of existing networks, driven by the need for the processing, transmission and switching of digital voice, data and video traffic over multiple communication media, at numerous transmission data rates and employing different protocols. However, 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. These factors have caused substantial fluctuations in our revenues and our results of operations in the past, and we may experience cyclical fluctuations in our business in the future.

### **Spin-off from Conexant Systems, Inc.**

On June 27, 2003, Conexant completed the distribution to Conexant stockholders of all outstanding shares of common stock of Mindspeed, then a wholly owned subsidiary of Conexant. In the distribution, each Conexant stockholder received one share of our common stock, par value \$.01 per share (including an associated preferred share purchase right), for every three shares of Conexant common stock held and cash for any fractional share of our common stock. Following the distribution, we began operations as an independent, publicly held company. Our common stock now trades on the Nasdaq National Market under the ticker symbol **MSPD**.

Prior to the distribution, Conexant transferred to us the assets and liabilities of its Mindspeed business, including the stock of certain subsidiaries, and certain other assets and liabilities which were allocated to us under the Distribution Agreement entered into between us and Conexant. Also prior to the distribution, Conexant contributed to us cash in an amount such that at the time of the distribution our cash balance was \$100 million. We issued to Conexant a warrant to purchase 30 million shares of our common stock at a price of \$3.408 per share, exercisable for a period of ten years after the distribution. We and Conexant also entered into a Credit Agreement, an Employee Matters Agreement, a Tax Allocation Agreement, a Transition Services Agreement and a Sublease.

### **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 inventories, allowances for doubtful accounts, revenue recognition,



**Table of Contents**

impairment of long-lived assets and income taxes. 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.

*Inventories* We write down our inventory for estimated obsolete or unmarketable inventory in an amount equal to the difference between the cost of inventory and the estimated market value based upon assumptions about future demand and market conditions. If actual market conditions are less favorable than our estimates, additional inventory write-downs may be required. In the event we experience unanticipated demand and are able to sell a portion of the inventories we have previously written down, our gross margins will be favorably affected.

*Allowance for Doubtful Accounts* We maintain allowances for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. Our estimates of such losses are based on an assessment of the aging of outstanding accounts receivable and a review of specific customer accounts. If the financial condition of our customers were to deteriorate, our actual losses may exceed our estimates and additional allowances would be required.

*Revenue Recognition* We recognize revenues when the following fundamental criteria are met: (i) persuasive evidence of an arrangement exists; (ii) delivery has occurred; (iii) our price to the customer is fixed or determinable; and (iv) collection of the sales price is reasonably assured. Delivery occurs when goods are shipped and title and risk of loss transfer to the customer, in accordance with the terms specified in the arrangement with the customer. Revenue recognition is deferred in all instances where the earnings process is incomplete. We make certain product sales 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 estimated sales returns and allowances in the same period as the related revenues are recognized. We base these estimates on our historical experience or the specific identification of an event necessitating a reserve. To the extent actual sales returns differ from our estimates, our future results of operations may be affected. Development revenue is recognized when services are performed and was not significant for any of the periods presented.

*Impairment of Long-Lived Assets* We continually monitor and review long-lived assets, including fixed assets, goodwill and intangible assets, 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.

*Deferred Income Taxes* We have provided a full valuation allowance against our deferred tax assets. If sufficient evidence of our ability to generate sufficient future taxable income in certain tax jurisdictions becomes apparent, we may be required to reduce our valuation allowance, resulting in income tax benefits in our statement of operations. We evaluate the realizability of our deferred tax assets and assess the need for a valuation allowance quarterly.

**Recent Accounting Pronouncements**

In December 2004, the FASB issued SFAS 123R, *Share-Based Payment*. Under SFAS 123R, we will no longer be able to account for share-based compensation transactions using the intrinsic value method of APB 25. Instead, we will be required to account for such transactions using a fair-value method and to recognize the fair value of each award over the service period. SEC Release No. 33-8568 makes SFAS 123R effective for fiscal years beginning after June 15, 2005, and SFAS 123R allows for several alternative transition methods. We expect to adopt SFAS 123R as of the beginning of the fiscal 2006 first quarter using modified prospective application, which will require that we recognize compensation expense for new awards, modified awards and for any awards outstanding at the effective date but vesting after such date. The actual amounts of stock compensation expense we recognize in



**Table of Contents**

periods following the adoption of SFAS 123R will depend on a number of factors, including the types of awards we make, the specific terms of awards, changes in the market price of our common stock and other factors. Our current plans regarding our future use of stock-based compensation are discussed below. Although we are currently evaluating the impact of SFAS 123R on our results of operations, we expect that the adoption of SFAS 123R will significantly increase our operating expenses for fiscal 2006 and thereafter. See **Stock-Based Compensation Programs**, below. In November 2004, the FASB issued SFAS No. 151, **Inventory Costs**, an amendment of Accounting Research Bulletin (ARB) No. 43, Chapter 4. SFAS 151 amends the guidance in ARB No. 43 to clarify that abnormal amounts of idle facility expense, freight, handling costs and wasted material (spoilage) should be recognized as current-period charges. In addition, SFAS 151 requires that allocation of fixed production overhead to the costs of conversion be based on the normal capacity of the production facilities. We must adopt SFAS 151 as of the beginning of fiscal 2006, and we do not expect that the adoption of SFAS 151 will have a material impact on our financial condition or results of operations.

In May 2005, the FASB issued SFAS No. 154, **Accounting Changes and Error Corrections**, which replaces APB Opinion No. 20, **Accounting Changes**, and SFAS No. 3, **Reporting Accounting Changes in Interim Financial Statements**. SFAS No. 154 applies to all voluntary changes in accounting principle and requires retrospective application (a term defined by the statement) to prior periods' financial statements, unless it is impracticable to determine the effect of a change. It also applies to changes required by an accounting pronouncement that does not include specific transition provisions. SFAS 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. We will adopt SFAS No. 154 as of the beginning of fiscal 2007, and we do not expect that the adoption of SFAS 154 will have a material impact on our financial condition or results of operations.

**Stock-Based Compensation Programs**

We use stock-based compensation to attract and retain employees and to provide long-term incentive compensation that aligns the interests of our employees with those of our stockholders. Historically, our stock-based compensation consisted principally of stock options. Eligible employees received a grant of stock options at the time of hire; we also made broad-based stock option grants covering substantially all of our employees annually. Stock option awards have exercise prices equal to the market price of our common stock at the grant date and are subject to time-based vesting (generally over four years). From time to time we have also used restricted stock awards with time-based vesting for incentive or retention purposes.

For fiscal 2006, we plan to revise our compensation arrangements to provide both current and long-term incentive compensation. Stock-based compensation is expected to principally consist of restricted stock awards. A portion of the restricted stock awards is intended to provide performance emphasis and incentive compensation through vesting tied to each employee's performance against individual goals. Additional restricted stock awards to certain senior management personnel are expected to have vesting tied to improvements in our company operating performance. The remainder of the restricted stock awards, intended to provide long-term incentive compensation, is expected to vest ratably over a period of four years (subject to continued service). From time to time, we may also grant stock options or other stock-based awards for incentive or retention purposes. We expect to further revise our compensation arrangements for fiscal 2007 and thereafter based on regular assessment of the effectiveness of our compensation arrangements and to keep our overall compensation package at market levels.

The fair value of restricted stock awards under this program will be measured based upon the market price of our common stock at the date of grant. The fair value of each award will be recognized on a straight-line basis over the vesting or service period. The actual amounts of expense we record in each fiscal period will depend on a number of factors, including the number of restricted shares awarded, the market price of our common stock, the vesting periods, the number of awards that ultimately vest and other factors.

**Table of Contents**

As required by SFAS 123R, our stock compensation expense for fiscal 2006 and thereafter will also include the value of awards outstanding at September 30, 2005 but vesting after that date. Based on all awards of stock-based compensation we have made through June 30, 2005, we expect the amount of such expense, by fiscal year, will be at least \$4.2 million (2006), \$1.8 million (2007) and \$0.5 million (2008). However, the actual amounts of such expense will depend on the quantity and terms of additional awards, forfeitures of outstanding awards or other factors.

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

The following table summarizes our net revenues:

| (\$ in millions) | Three months ended June 30, |        |        | Nine months ended June 30, |        |        |
|------------------|-----------------------------|--------|--------|----------------------------|--------|--------|
|                  | 2005                        | Change | 2004   | 2005                       | Change | 2004   |
| Net revenues     | \$27.7                      | (22)%  | \$35.4 | \$80.7                     | (13)%  | \$92.9 |

In the third quarter and first nine months of fiscal 2004, our revenues benefited from strong end-customer demand for network infrastructure equipment that uses our products and a build-up in inventory levels at a number of our key customers. As a result, our revenues for the fiscal 2004 third quarter reached \$35.4 million, their highest level in three years. Beginning in the fourth quarter of fiscal 2004, our revenues have been affected by a drop in end-customer demand particularly in China associated with slower capital spending. These market conditions have affected our revenues through the first nine months of fiscal 2005.

The decrease in our net revenues for the first nine months of fiscal 2005 compared to the similar fiscal 2004 period principally reflects lower sales volumes in our T/E carrier products and our ATM/MPLS network processor products. The decrease in revenues from our T/E carrier products principally reflects lower demand for our T1/E1 and T3/E3 line interface units and digital subscriber line (DSL) transceivers resulting from a slowdown in consumption of our products in access and metropolitan area network applications. We also experienced lower demand for our ATM/MPLS network processor products for use in wireless, enterprise and broadband infrastructure applications. These decreases were partially offset by increased shipments of our multiservice access DSP products and, to a lesser extent, our high performance analog products. Sales of our multiservice access DSP products benefited from increased shipments of our Comcerto series VoIP processors for use in VoIP applications, partially offset by weaker demand in China in the fiscal 2005 period.

The decrease in our net revenues for the third quarter of fiscal 2005 compared to 2004 principally reflects lower demand for our T/E carrier products, as discussed above, and lower sales volumes across the majority of our family of high-performance analog products. The decrease in our revenues also reflects lower sales volumes in our ATM/MPLS network processor products and multiservice access DSP products. Within our multiservice access DSP products, the significantly increased sales of our Comcerto VoIP processors were offset by lower shipments of our legacy multiservice access processors.

**Gross Margin**

| (\$ in millions)        | Three months ended June 30, |        |        | Nine months ended June 30, |        |        |
|-------------------------|-----------------------------|--------|--------|----------------------------|--------|--------|
|                         | 2005                        | Change | 2004   | 2005                       | Change | 2004   |
| Gross margin            | \$19.5                      | (23)%  | \$25.2 | \$56.2                     | (16)%  | \$66.7 |
| Percent of net revenues | 70%                         |        | 71%    | 70%                        |        | 72%    |

Gross margin represents net revenues less cost of goods sold. As a fabless semiconductor company, we use third parties (including Taiwan Semiconductor Manufacturing Co., Ltd. (TSMC), Jazz and Amkor Technology, Inc.) for wafer fabrication and 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; labor and overhead costs associated with product procurement; and sustaining engineering expenses pertaining to products sold.

Our gross margin for the third quarter and first nine months of fiscal 2005 compared to the similar fiscal 2004 period principally reflects the decrease in our net revenues. For the third quarter of fiscal 2005 and 2004, our gross margin also included a benefit of \$1.7 million and \$2.5 million, respectively, from the sale of inventories that we had written down to a zero cost basis during fiscal 2001. These sales resulted from renewed demand for certain products that was

not anticipated at the time of the write-downs. The majority of the previously written-down inventories



**Table of Contents**

were sold at prices which exceeded their original cost. For the first nine months of fiscal 2005 and 2004, our gross margin included a benefit of \$7.2 million and \$6.3 million, respectively, from the sale of inventories that we had written down to a zero cost basis during fiscal 2001.

In fiscal 2001, we recorded an aggregate of \$83.5 million of inventory write-downs, reducing the cost basis of the affected inventories to zero. The fiscal 2001 inventory write-downs resulted from the sharply reduced end-customer demand for network infrastructure equipment during that period. As a result of these market conditions, we experienced a significant number of order cancellations and a decline in the volume of new orders beginning in the fiscal 2001 first quarter. The inventories written down in fiscal 2001 principally consisted of multiservice access processors and DSL transceivers.

We assess the recoverability of our inventories at least quarterly through a review of inventory levels in relation to foreseeable demand (generally over twelve months). Foreseeable demand is based upon all available information, including sales backlog and forecasts, product marketing plans and product life cycles. 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.

Our products are used by OEMs that have designed our products into network infrastructure 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. 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.

From the time of the fiscal 2001 inventory write-downs through June 30, 2005, we scrapped a portion of these inventories having an original cost of \$35.9 million and sold a portion of these inventories with an original cost of \$24.9 million. The sales resulted from increased demand beginning in the first quarter of fiscal 2002 which was not anticipated at the time of the write-downs. As of June 30, 2005, we continued to hold inventories with an original cost of \$22.6 million which were previously written down to a zero cost basis. We currently intend to hold these remaining inventories and will sell these inventories if we experience renewed demand for these products. While there can be no assurance that we will be able to do so, if we are able to sell a portion of the inventories which are carried at zero cost basis, our gross margins will be favorably affected by an amount equal to the original cost of the zero-cost basis inventory sold. To the extent that we do not experience renewed demand for the remaining inventories, they will be scrapped as they become obsolete.

We base our assessment of the recoverability of our inventories, and the amounts of any write-downs, on currently available information and assumptions about future demand and market conditions. Demand for our products may fluctuate significantly over time, and actual demand and market conditions may be more or less favorable than those projected by management. In the event that actual demand is lower than originally projected, additional inventory write-downs may be required.

**Research and Development**

| (\$ in millions)         | Three months ended June 30, |        |        | Nine months ended June 30, |        |        |
|--------------------------|-----------------------------|--------|--------|----------------------------|--------|--------|
|                          | 2005                        | Change | 2004   | 2005                       | Change | 2004   |
| Research and development | \$16.7                      | (12)%  | \$19.1 | \$55.0                     | (8)%   | \$59.6 |
| Percent of net revenues  | 60%                         |        | 54%    | 68%                        |        | 64%    |

Our research and development (R&D) expenses consist principally of direct personnel costs, photomasks, electronic design automation tools and pre-production evaluation and test costs. The decrease in R&D expenses for the third quarter and first nine months of fiscal 2005 compared to the comparable fiscal 2004 periods primarily reflects lower headcount and personnel-related costs resulting from our expense reduction actions as well as lower supplies costs.

We anticipate further reductions in our R&D expenses under our 2004 restructuring plan discussed below.



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

| (\$ in millions)                    | Three months ended June 30, |        |        | Nine months ended June 30, |        |        |
|-------------------------------------|-----------------------------|--------|--------|----------------------------|--------|--------|
|                                     | 2005                        | Change | 2004   | 2005                       | Change | 2004   |
| Selling, general and administrative | \$10.8                      | (15)%  | \$12.7 | \$31.9                     | (10)%  | \$35.6 |
| Percent of net revenues             | 39%                         |        | 36%    | 40%                        |        | 38%    |

Our selling, general and administrative (SG&A) expenses include personnel costs, independent sales representative commissions and product marketing, applications engineering and other marketing costs. Our SG&A expenses also include costs of corporate functions including accounting, finance, legal, human resources, information systems and communications. The decrease in our SG&A expenses for the third quarter and first nine months of fiscal 2005 compared to the comparable fiscal 2004 periods primarily reflects the positive impact of lower headcount and personnel-related costs resulting from our expense reduction and restructuring actions as well as lower selling costs resulting from lower sales volumes in the fiscal 2005 periods.

We anticipate further reductions in our SG&A expenses under our 2004 restructuring plan discussed below.

**Amortization of Intangible Assets**

| (\$ in millions)                  | Three months ended June 30, |        |        | Nine months ended June 30, |        |        |
|-----------------------------------|-----------------------------|--------|--------|----------------------------|--------|--------|
|                                   | 2005                        | Change | 2004   | 2005                       | Change | 2004   |
| Amortization of intangible assets | \$0.8                       | (93)%  | \$12.6 | \$20.5                     | (46)%  | \$37.7 |
| Percent of net revenues           | 3%                          |        | 36%    | 25%                        |        | 41%    |

The decrease in amortization expense in the third quarter and first nine months of fiscal 2005 compared to the fiscal 2004 periods principally reflects assets becoming fully amortized. Intangible assets are amortized over periods averaging approximately five years for each major asset class and extending to various dates through June 2005. As of June 30, 2005, this periodic amortization has reduced the carrying value of our intangible assets to zero and we will not record any additional amortization expense on our existing intangible assets in future periods.

**Special Charges**

Special charges consist of the following:

| (\$ in millions)      | Three months ended June 30, |      | Nine months ended June 30, |        |
|-----------------------|-----------------------------|------|----------------------------|--------|
|                       | 2005                        | 2004 | 2005                       | 2004   |
| Asset impairments     | \$                          | \$   | \$ 0.6                     | \$     |
| Restructuring charges | (0.1)                       |      | 5.3                        | 0.4    |
|                       | \$ (0.1)                    | \$   | \$ 5.9                     | \$ 0.4 |

**Asset Impairments**

During the first nine months of fiscal 2005, we recorded asset impairment charges totaling \$604,000 related to property and equipment that we determined to abandon or scrap.

We continually monitor and review long-lived assets, including fixed assets and intangible assets, for possible impairment. Future impairment tests may result in significant write-downs of the value of our assets.

**Restructuring Charges**

*Mindspeed 2004 Restructuring Plan* In October 2004, we announced a restructuring plan intended to reduce our operating expenses while focusing our research and development investment in key high-growth markets, including VoIP and high-performance analog applications. We expect these actions will reduce our combined research and development and selling, general and administrative expenses from \$31.2 million for the fourth quarter of fiscal 2004 to approximately \$26 million in the fourth quarter of fiscal 2005, a decrease of approximately 17 percent.

The expense reduction actions under the restructuring plan include workforce reductions and the closure of a design center in Herzlia, Israel. Approximately 80% of the anticipated expense reductions is expected to come from the termination of research and development programs which we believe have a longer return-on-investment timeframe

**Table of Contents**

or that address slower growth markets. The affected research and development programs are principally our ATM/MPLS network processor products and, to a lesser extent, our T/E carrier transmission products. The remainder of the expected cost savings is expected to come from the selling, general and administrative functions. Through June 30, 2005, we had completed the majority of these actions, reducing our workforce by approximately 80 employees. The remaining cost reduction actions under this restructuring plan consist of the closure of our Lisle, Illinois design center and related workforce reductions. We expect to complete these actions by the end of fiscal 2005, bringing the total reduction in our workforce to approximately 90 employees.

In connection with these actions, we recorded restructuring charges of approximately \$5.3 million during the first nine months of fiscal 2005. The restructuring charges included an aggregate of \$2.8 million for severance benefits payable to the affected employees and approximately \$2.5 million related to contractual obligations for the purchase of design tools and other services in excess of our requirements. We expect to record additional fiscal 2005 restructuring charges totaling approximately \$0.4 million to complete these cost reduction actions. We expect to pay the majority of the restructuring costs in cash during fiscal 2005.

Activity and liability balances related to the Mindspeed 2004 restructuring plan through June 30, 2005 are as follows (in thousands):

|                                      | <b>Workforce<br/>Reductions</b> | <b>Facility<br/>and Other</b> | <b>Total</b> |
|--------------------------------------|---------------------------------|-------------------------------|--------------|
| Charged to costs and expenses        | \$ 2,824                        | \$2,517                       | \$ 5,341     |
| Cash payments                        | (2,200)                         | (383)                         | (2,583)      |
| Restructuring balance, June 30, 2005 | \$ 624                          | \$2,134                       | \$ 2,758     |

*Other Restructuring Plans* In fiscal 2001, 2002 and 2003, we implemented a number of cost reduction initiatives to improve our operating cost structure. The cost reduction initiatives included workforce reductions, significant reductions in capital spending, the consolidation of certain facilities and salary reductions for the senior management team. During the nine months ended June 30, 2005, we reversed \$89,000 of previously accrued costs upon the resolution of liabilities for certain contractual obligations. Cash payments under these restructuring plans were \$1.6 million for the nine months ended June 30, 2005 and, as of June 30, 2005, our remaining liabilities under these restructuring plans totaled \$3.1 million.

As of June 30, 2005, we have a remaining accrued restructuring balance totaling \$5.8 million (including \$2.4 million classified as a long-term liability), principally representing obligations under non-cancelable leases and other contractual commitments. We expect to pay these obligations over their respective terms, which expire at various dates through fiscal 2008. The payments will be funded from available cash balances and funds from product sales and are not expected to impact significantly our liquidity.

**Other Income (Expense), Net**

| (\$ in millions)            | <b>Three months ended June<br/>30,</b> |             | <b>Nine months ended June<br/>30,</b> |             |
|-----------------------------|--|-------------|---------------------------------------|-------------|
|                             | <b>2005</b>                            | <b>2004</b> | <b>2005</b>                           | <b>2004</b> |
| Other income (expense), net | \$ (0.2)                               | \$ (0.1)    | \$ (0.4)                              | \$ 0.3      |
| Percent of net revenues     | (1)%                                   | %           | (1)%                                  | %           |

Other income (expense), net principally consists of interest income and expense, foreign exchange gains and losses and other non-operating gains and losses. Other income (expense) for the third quarter and first nine months of fiscal 2005 compared to fiscal 2004 periods reflects interest expense on the \$46 million convertible senior notes issued in December 2004 and, for the first nine months of fiscal 2005, the write-off of capitalized costs associated with the terminated credit facility, partially offset by higher interest income on invested cash balances.

**Provision for Income Taxes**

Our provision for income taxes for the third quarter and first nine months of fiscal 2005 and 2004 principally consisted of income taxes incurred by our foreign subsidiaries. As a result of our operating losses and our expectation of future operating results, we determined that it is more likely than not that the additional income tax benefits (principally net operating losses we can carry forward to future years) which arose during the third quarter and first nine months of fiscal 2005 and 2004 will not be realized. Accordingly, we have not recognized any income

**Table of Contents**

tax benefits relating to our operating losses for those periods and 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. We expect that our provision for income taxes for fiscal 2005 will principally consist of income taxes related to our foreign operations.

**Liquidity and Capital Resources**

Cash used in operating activities was \$22.8 million for the first nine months of fiscal 2005 compared to \$33.3 million for the first nine months of fiscal 2004. Operating cash flows for the first nine months of fiscal 2005 reflect our net loss of \$58.3 million, partially offset by non-cash charges (depreciation and amortization, special charges and other) of \$29.9 million, and net working capital decreases of approximately \$5.6 million. Operating cash flows for the first nine months of fiscal 2005 include interest payments on our convertible senior notes of \$767,000.

The net working capital decreases for the first nine months of fiscal 2005 included a \$5.0 million decrease in accounts receivable resulting from a decrease in our average collection period and a \$948,000 decrease in net inventories.

These amounts were partially offset by a \$785,000 decrease in accounts payable, principally related to the timing of vendor payments.

Cash used in investing activities of \$46.3 million for the first nine months of fiscal 2005 principally consisted of net purchases of marketable securities of \$43.3 million and capital expenditures of \$3.2 million, partly offset by proceeds from asset sales of \$149,000. For the first nine months of fiscal 2004, cash used in investing activities of \$3.9 million principally consisted of capital expenditures.

Cash provided by financing activities of \$46.4 million for the first nine months of fiscal 2005 consisted of net proceeds of \$43.9 million from the sale of \$46 million principal amount of convertible senior notes and proceeds of \$2.9 million from the exercise of stock options and warrants, partially offset by debt issuance costs of \$433,000. Cash provided by financing activities of \$11.8 million for the first nine months of fiscal 2004 principally consisted of proceeds from the exercise of stock options and warrants.

*Convertible Senior Notes Offering*

In December 2004, we sold \$46.0 million aggregate principal amount of Convertible Senior Notes due 2009 for net proceeds (after discounts and commissions) of approximately \$43.9 million. The notes are senior unsecured obligations, ranking equal in right of payment with all future unsecured indebtedness. The notes bear interest at a rate of 3.75%, payable semiannually in arrears each May 18 and November 18. We used approximately \$3.3 million of the proceeds to purchase U.S. government securities that have been pledged to the trustee for the payment of the first four scheduled interest payments on the notes when due.

The notes are convertible, at the option of the holder, at any time prior to maturity into shares of our common stock. Upon conversion, we may, at our option, elect to deliver cash in lieu of shares of our common stock or a combination of cash and shares of common stock. Effective May 13, 2005, the conversion price of the notes was adjusted to \$2.31 per share of common stock, which is equal to a conversion rate of approximately 432.9004 shares of common stock per \$1,000 principal amount of notes. Prior to this adjustment, the conversion price applicable to the notes was \$2.81 per share of common stock, which was equal to approximately 355.8719 shares of common stock per \$1,000 principal amount of notes. The adjustment was made pursuant to the terms of the indenture governing the notes. The conversion price is subject to further adjustment under the terms of the indenture to reflect stock dividends, stock splits, issuances of rights to purchase shares of common stock and certain other events.

If we undergo certain fundamental changes (as defined in the indenture), holders of notes may require us to repurchase some or all of their notes at 100% of the principal amount plus accrued and unpaid interest. If, upon notice of certain events constituting a fundamental change, holders of the notes elect to convert the notes, we will be required to increase the number of shares issuable upon conversion by up to 78.9 shares per \$1,000 principal amount of notes.

The number of additional shares, if any, will be determined by the table set forth in the indenture governing the notes. In the event of a non-stock change of control constituting a public acquirer change of control (as defined in the indenture), we may, in lieu of issuing additional shares or making an additional cash payment upon conversion as required by the indenture, elect to adjust the conversion price and the related conversion obligation such that the noteholders will be entitled to convert their notes into a number of shares of public acquirer common stock.





## **Table of Contents**

For financial accounting purposes, our contingent obligation to issue additional shares or make an additional cash payment upon conversion following a fundamental change is an embedded derivative. As of June 30, 2005, the estimated fair value of our liability under the fundamental change adjustment was not significant.

In connection with the sale of the notes, we granted the purchasers certain registration rights. Our Form S-3 registration statement covering the resale of the notes and the sale of shares issuable upon conversion of the notes was declared effective by the Securities and Exchange Commission on April 6, 2005.

Upon completion of the sale of the notes, the \$50 million Credit Agreement with Conexant was terminated. We had made no borrowings under the credit facility, and no portion of the related warrant is, or will become, exercisable.

### *Agreements with Conexant*

In the distribution, we issued to Conexant a warrant to purchase 30 million shares of our common stock at a price of \$3.408 per share, exercisable for a period of ten years after the distribution. The warrant contains antidilution provisions that provide for adjustment of the exercise price, and the number of shares issuable under the warrant, upon the occurrence of certain events. If we issue, or are deemed to have issued, shares of our common stock, or securities convertible into our common stock, at prices below the current market price of our common stock (as defined in the warrants) at the time of the issuance of such securities, the warrant's exercise price will be reduced and the number of shares issuable under the warrant will be increased. The amount of such adjustment, if any, will be determined pursuant to a formula specified in the warrant and will depend on the number of shares issued, the offering price and the current market price of our common stock at the time of the issuance of such securities. Adjustments to the warrant pursuant to these antidilution provisions may result in significant dilution to the interests of our existing stockholders and may adversely affect the market price of our common stock. The antidilution provisions may also limit our ability to obtain additional financing on terms favorable to us.

Moreover, we may not realize any cash proceeds from the exercise of the warrant held by Conexant. A holder of the warrant may opt for a cashless exercise of all or part of the warrant. In a cashless exercise, the holder of the warrant would make no cash payment to us and would receive a number of shares of our common stock having an aggregate value equal to the excess of the then-current market price of the shares of our common stock issuable upon exercise of the warrant over the exercise price of the warrant. Such an issuance of common stock would be immediately dilutive to the interests of other stockholders.

### *Liquidity*

Our principal sources of liquidity are our existing cash balances, marketable securities and cash generated from product sales. As of June 30, 2005, our cash and cash equivalents totaled \$20.9 million and our marketable securities totaled \$43.3 million. Our working capital at June 30, 2005 was \$63.5 million.

In order to achieve profitability, or to generate positive cash flows from operations, we must achieve substantial revenue growth. Our ability to achieve the necessary revenue growth will depend on increased demand for network infrastructure equipment that incorporates our products, which in turn depends primarily on the level of capital spending by communications service providers and enterprises. In October 2004, we announced additional cost reduction actions designed to reduce our combined quarterly research and development and selling, general and administrative expenses to approximately \$26 million by the fourth quarter of fiscal 2005. However, these expense reductions alone, without additional revenue growth, will not make us profitable. We expect to continue to incur significant losses and negative cash flows at least through the first half of fiscal 2006 and we may incur additional significant losses and negative cash flows in subsequent periods.

We believe that our existing sources of liquidity, along with cash expected to be generated from product sales, will be sufficient to fund our operations, research and development efforts, anticipated capital expenditures, working capital and other financing 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

**Table of Contents**

seek to obtain additional debt or equity financing. We may also need to seek to obtain additional debt or equity financing if we experience downturns or cyclical fluctuations in our business that are more severe or longer than anticipated or if we fail to achieve anticipated revenue and expense levels. However, we cannot assure you that such financing will be available to us on favorable terms, or at all.

**Contractual Obligations**

The following table summarizes the future payments we are required to make under contractual obligations as of June 30, 2005:

| Contractual Obligations            | Total  | Payments due by period |                               |           |             |
|------------------------------------|--------|------------------------|-------------------------------|-----------|-------------|
|                                    |        | <1 year                | 1-3 years<br>(in<br>millions) | 3-5 years | >5<br>years |
| Long-term debt                     | \$46.0 | \$                     | \$                            | \$46.0    | \$          |
| Interest expense on long-term debt | 7.8    | 1.7                    | 3.5                           | 2.6       |             |
| Operating leases                   | 26.5   | 9.6                    | 16.2                          | 0.7       |             |
| Purchase obligations               | 9.4    | 4.6                    | 3.9                           | 0.9       |             |
| Total                              | \$89.7 | \$15.9                 | \$23.6                        | \$50.2    | \$          |

Long-term debt consists of \$46.0 million aggregate principal amount of our Convertible Senior Notes. The notes bear interest at a rate of 3.75%, payable semiannually in arrears each May 18 and November 18, and mature on November 18, 2009. U.S. Treasury securities having an aggregate face amount of approximately \$2.6 million are pledged to the trustee for the payment of the next three scheduled interest payments on the notes when due.

In March 2005, we amended and restated the Sublease with Conexant pursuant to which we lease our headquarters in Newport Beach, California. The Sublease has an initial term extending through June 2008 and we may, at our option, extend the Sublease for an additional two-year term. Rent payable under the Sublease will initially be approximately \$3.9 million annually, subject to annual increases of 3%, plus a prorated portion of operating expenses associated with the leased property. We estimate our minimum future obligation under the Sublease at approximately \$6.1 million annually (a total of \$18.7 million over the remainder of the initial lease term), but actual costs under the Sublease will vary based upon Conexant's actual costs. In addition, each year we may elect to purchase certain services from Conexant based on a prorated portion of Conexant's actual costs.

We lease our other facilities and certain equipment under non-cancelable operating leases. The leases expire at various dates through 2010 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. Contractual obligations under operating leases have not been reduced by anticipated rental income under noncancelable subleases totaling \$2.8 million and extending to various dates through fiscal 2008.

**Off-Balance Sheet Arrangements**

We have made guarantees and indemnities, under which we may be required to make payments to a guaranteed or indemnified party, in relation to certain transactions. In connection with the distribution, we generally assumed responsibility for all contingent liabilities and then-current and future litigation against Conexant or its subsidiaries related to the Mindspeed business. We may also be responsible for certain federal income tax liabilities under the Tax Allocation Agreement between us and Conexant, which provides that we will be responsible for certain taxes imposed on us, Conexant or Conexant stockholders. In connection with certain facility leases, we have indemnified our lessors for certain claims arising from the facility or the lease. We indemnify our directors, officers, employees and agents to the maximum extent permitted under the laws of the State of Delaware. The duration of the guarantees and indemnities varies, and in many cases is indefinite. The majority of our guarantees and indemnities do not provide for any limitation of the maximum potential future payments we could be obligated to make. We have not recorded any liability for these guarantees and indemnities in the accompanying consolidated balance sheets.

**Certain Business Risks**

Our business, financial condition and operating results can be affected by a number of factors, including those listed below, 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 also materially and adversely affect our business, financial condition or the price of our common stock or other securities.

**Table of Contents**

***We are incurring substantial operating losses, we anticipate additional future losses and we must significantly increase our revenues to become profitable.***

We incurred a net loss of \$58.3 million for the first nine months of fiscal 2005 compared to a net loss of \$67.7 million in the first nine months of fiscal 2004. We incurred net losses of \$93.2 million in fiscal 2004 and \$750.4 million (\$177.3 million, before the \$573.2 million cumulative effect of a change in accounting for goodwill) in fiscal 2003. We expect that we will continue to incur significant losses and negative cash flows at least through the first half of fiscal 2006 and we may incur additional significant losses and negative cash flows in subsequent periods.

In order to become profitable, or to generate positive cash flows from operations, we must achieve substantial revenue growth. Our ability to achieve the necessary revenue growth will depend on increased demand for network infrastructure equipment that incorporates our products, which in turn depends primarily on the level of capital spending by communications service providers and enterprises. In October 2004, we announced additional cost reduction actions designed to reduce our combined quarterly research and development and selling, general and administrative expenses to approximately \$26 million by the fourth quarter of fiscal 2005. However, these expense reductions alone, without additional revenue growth, will not make us profitable. We may not be successful in achieving the necessary revenue growth or the expected expense reductions within the anticipated time frame, or at all. We may not achieve profitability or sustain such profitability, if achieved.

***We have substantial cash requirements to fund our operations, research and development efforts and capital expenditures. Our capital resources are limited and capital needed for our business may not be available when we need it.***

For the first nine months of fiscal 2005, our net cash used in operating activities was \$22.8 million compared to net cash used in operating activities of \$33.3 million for the first nine months of fiscal 2004. Net cash used in operating activities was \$43.2 million for fiscal 2004 and \$125.6 million for fiscal 2003. Our principal sources of liquidity are our existing cash balances, and marketable securities and cash generated from product sales. As of June 30, 2005, our cash and cash equivalents totaled \$20.9 million and our marketable securities totaled \$43.3 million. We believe that our existing sources of liquidity will be sufficient to fund our operations, research and development efforts, 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 if we continue to incur operating losses and negative cash flows in the future, we may need to reduce further our operating costs or obtain alternate sources of financing, or both. We may not have access to additional sources of capital on favorable terms or at all. If we raise additional funds through the issuance of equity, equity-based or debt securities, such securities may have rights, preferences or privileges senior to those of our common stock and our stockholders may experience dilution of their ownership interests.

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

Our future success depends on our ability to attract, retain and motivate qualified personnel, including executive officers and other key management and technical personnel. As the source of our technological and product innovations, our key technical personnel represent a significant asset. The competition for such personnel can be intense in the semiconductor industry. We may not 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. If we are not successful in assuring our employees of our financial stability and our prospects for success, our employees may seek other employment, which may materially adversely affect our business. Moreover, our recent expense reduction and restructuring initiatives, including a series of worldwide workforce reductions, have significantly reduced the number of our technical employees. The loss of the services of one or more of our key employees, including Raouf Y. Halim, our chief executive officer, 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.

Approximately 10% of our engineers are foreign nationals working in the United States under visas. The visas held by many of our employees permit qualified foreign nationals working in specialty occupations, such as certain categories

of engineers, to reside in the United States during their employment. The number of new visas approved

**Table of Contents**

each year may be limited and may restrict our ability to hire additional qualified technical employees. In addition, immigration policies are subject to change, and these policies have generally become more stringent since the events of September 11, 2001. Any additional significant changes in immigration laws, rules or regulations may further restrict our ability to retain or hire technical personnel.

***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 in general, 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 our results of operations in the past and we may experience similar fluctuations in our business in the future.

***Our operating results are subject to substantial quarterly and annual fluctuations.***

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

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

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

fluctuations in the levels of component inventories held by our customers;

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;

fluctuations in manufacturing yields;

significant warranty claims, including those not covered by our suppliers;

availability and cost of products from our suppliers;

intellectual property disputes; and

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

The foregoing factors are difficult to forecast, and these, as well as other factors, could materially adversely affect our quarterly or annual operating results. If our operating results fail to meet the expectations of analysts or investors, it could materially and adversely affect the price of our common stock.

***We are entirely dependent upon third parties for the manufacture, assembly and testing of our products and are vulnerable to their capacity constraints during times of increasing demand for semiconductor products.***

We are entirely dependent upon outside wafer fabrication facilities, known as foundries, for wafer fabrication services. Under our fabless business model, our long-term revenue growth is dependent on our ability to obtain sufficient external manufacturing capacity, including wafer production capacity. Periods of upturns in the semiconductor

industry may be characterized by rapid increases in demand and a shortage of wafer fabrication capacity, and we may experience delays in shipments or increased manufacturing costs.

The significant risks associated with our reliance on third-party foundries are compounded at times of increasing demand for semiconductor products. They include:

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

**Table of Contents**

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

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

We obtain external wafer manufacturing capacity primarily from TSMC and Jazz. However, these and other 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 complete the qualification process before we can begin shipping products from the new foundry.

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

Wafer fabrication processes are subject to obsolescence, and foundries may discontinue a wafer fabrication process used for certain of our products. In such event, we generally offer our customers a last-time buy program to satisfy their anticipated requirements for our products. The unanticipated discontinuation of a wafer fabrication process 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 the Asia-Pacific region, Mexico and California. In the event of a disruption of the operations of one or more of our suppliers, we may not have a second manufacturing source immediately available. Such an event could cause significant delays in shipments until we could shift the products from an affected facility or supplier to another facility or supplier. The manufacturing processes we rely on are specialized and are available from a limited number of suppliers. Alternate sources of manufacturing capacity, particularly wafer production capacity, may not be available to us on a timely basis. Even if alternate wafer production capacity is available, we may not be able to obtain it on favorable terms, or at all. Difficulties or delays in securing an adequate supply of our products on favorable terms, or at all, could impair our ability to meet our customers' requirements and have a material adverse effect on our operating results.

In addition, the highly complex and technologically demanding nature of semiconductor manufacturing has caused foundries to experience, from time to time, lower than anticipated manufacturing yields, particularly in connection with the introduction of new products and the installation and start-up of new process technologies. Lower than anticipated manufacturing yields may affect our ability to fulfill our customers' demands for our products on a 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 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 manufacturers 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, and is expected to continue to result, in declining average selling prices for our products. Many of our current and potential competitors have certain advantages over us, including:

stronger financial position and liquidity;

longer presence in key markets;

greater name recognition;

access to larger customer bases; and

significantly greater sales and marketing, manufacturing, distribution, technical and other resources.





**Table of Contents**

As a result, these competitors may be able to adapt more quickly to new or emerging technologies and changes in customer requirements or may be able to devote greater resources to the development, promotion and sale of their products than we can. Moreover, we have recently incurred substantial operating losses, and we anticipate future losses. Our OEM customers may choose semiconductor suppliers whom they believe have a stronger financial position or liquidity.

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 among competitors could emerge and rapidly acquire significant market share. We may not be able to compete successfully against current and potential competitors.

***Our success depends on our ability to develop competitive new products in a timely manner.***

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 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; and
- overall market acceptance of our products.

We may not have sufficient resources to make the substantial investment in research and development in order to develop and bring to market new and enhanced products, particularly if we are required to take further cost reduction actions. Furthermore, we are required to evaluate expenditures for planned product development continually and to choose among alternative technologies based on our expectations of future market growth. We may be unable to develop and introduce new or enhanced products in a timely manner, our products may not satisfy customer requirements or achieve market acceptance, or we may be unable to anticipate new industry standards and technological changes. We also may not be able to respond successfully to new product announcements and introductions by competitors.

***If we are not able to keep abreast of the rapid technological changes in our markets, our products could become obsolete.***

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

- rapid technological developments;
- rapid changes in customer requirements;
- frequent new product introductions and enhancements;
- declining prices over the life cycle of products; and
- evolving industry standards.

Our products could become obsolete sooner than we expect because of faster than anticipated, or unanticipated, changes in one or more of the technologies related to our products. The introduction of new technology representing a substantial advance over current technology could adversely affect demand for our existing products. Currently accepted industry standards are also subject to change, which may also contribute to the obsolescence of our products. If we are unable to develop and introduce new or enhanced products in a timely manner, our business may be adversely affected.



**Table of Contents*****The complexity of our products may lead to errors, defects and bugs, which could subject us to significant costs or damages and adversely affect market acceptance of our products.***

Although we, our customers and our suppliers rigorously test our products, our products are complex and may contain errors, defects or bugs when first introduced or as new versions are released. We have in the past experienced, and may in the future experience, such errors, defects and bugs. If any of our products contain production defects or reliability, quality or compatibility problems that are significant to our customers, our reputation may be damaged and customers may be reluctant to buy our products, which could adversely affect our ability to retain existing customers and attract new customers. In addition, these defects or bugs could interrupt or delay sales of affected products to our customers, which could adversely affect our results of operations.

If defects or bugs are discovered after commencement of commercial production of a new product, we may be required to make significant expenditures of capital and other resources to resolve the problems. This could result in significant additional development costs and the diversion of technical and other resources from our other development efforts. We could also incur significant costs to repair or replace defective products and we could be subject to claims for damages by our customers or others against us. These costs or damages could have a material adverse effect on our financial condition and results of operations.

***If network infrastructure OEMs 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 network infrastructure OEMs 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 is 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, 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 generally 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. These lengthy periods also increase 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 any revenues from new products. We may never generate the anticipated revenues if our customers cancel or change their product plans.

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

Our sales are typically made pursuant to individual purchase orders and we generally do not have long-term supply arrangements with our customers. Generally, our customers may cancel orders until 30 days prior to shipment. In addition, we sell a substantial portion of our products through distributors, some of whom have a right to return unsold products to us. Sales to distributors accounted for approximately 53% and 46%, respectively, of our net revenues for fiscal 2004 and the first nine months of fiscal 2005.

Because of the significant lead times for wafer fabrication and assembly and test services, we routinely purchase inventory based on estimates of end-market demand for our customers' products, which may be subject to dramatic changes and is difficult to predict. This difficulty may be compounded when we sell to OEMs indirectly through distributors 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.



**Table of Contents**

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

For fiscal 2004 and the first nine months of fiscal 2005, approximately 68% and 69% respectively, of our net revenues were from customers located outside the United States, primarily in the Asia-Pacific region and Europe. In addition, we have design centers, and rely on suppliers, located outside the United States, including foundries and assembly and test service providers located in the Asia-Pacific region. Our international sales and operations are subject to a number of risks inherent in selling and operating abroad which could adversely affect our ability to increase or maintain our foreign sales. These include, but are not limited to, risks regarding:

currency exchange rate fluctuations;

local economic and political conditions;

disruptions of capital and trading markets;

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

changes in legal or regulatory requirements;

difficulty in obtaining distribution and support;

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

tax laws; and

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

Because most of our international sales, other than sales to Japan (which are denominated principally in Japanese yen), are currently denominated in U.S. dollars, our products could become less competitive in international markets if the value of the U.S. dollar increases relative to foreign currencies.

From time to time we may enter into foreign currency forward exchange contracts to mitigate the 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 adversely affected 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 reduction in our intellectual property rights.***

The semiconductor industry is characterized by vigorous protection and pursuit of intellectual property rights. From time to time, third parties have asserted and may in the future assert patent, copyright, trademark and other intellectual property rights to technologies that are important to our business and have demanded and may in the future demand that we license their patents and technology. Any litigation to determine the validity of allegations that our products infringe or may infringe these rights, including claims arising through our contractual indemnification of our customers, or claims challenging the validity of our patents, regardless of its merit or resolution, could be costly and divert the efforts and attention of our management and technical personnel. We may not 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 for past, present and future use of the infringing technology;

cease the manufacture, use or sale of infringing products;

discontinue the use of infringing technology;

expend significant resources to develop non-infringing technology;

pay substantial damages to our customers or end users to discontinue use or replace infringing technology with non-infringing technology;

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

**Table of Contents**

relinquish intellectual property rights associated with one or more of our patent claims, if such claims are held invalid or otherwise unenforceable.

In connection with the distribution, we generally assumed responsibility for all contingent liabilities and litigation against Conexant or its subsidiaries related to the Mindspeed business.

***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 employee and third-party nondisclosure and confidentiality agreements and other methods, to protect our proprietary technologies and processes. At times we incorporate the intellectual property of our customers into our designs, and we have obligations with respect to the non-use and non-disclosure of their intellectual property. In the past, we have engaged in litigation to enforce our intellectual property rights, to protect our trade secrets or to determine the validity and scope of proprietary rights of others, including our customers. We may engage in future litigation on similar grounds, which may require us to expend significant resources and to divert the efforts and attention of our management from our business operations. In particular:

the steps we take to prevent misappropriation or infringement of our intellectual property or the intellectual property of our customers may not be successful;

any existing or future patents may be challenged, invalidated or circumvented; or

the measures described above may not provide meaningful protection.

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

***We may make business acquisitions or investments, which involve significant risk.***

We may from time to time make acquisitions, enter into alliances or make investments in other businesses to complement our existing product offerings, augment our market coverage or enhance our technological capabilities. However, any such transactions could result in:

issuances of equity securities dilutive to our existing stockholders;

the incurrence of substantial debt and assumption of unknown liabilities;

large one-time write-offs;

amortization expenses related to intangible assets;

the diversion of management's attention from other business concerns; and

the potential loss of key employees from the acquired business.

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.

Additionally, in periods subsequent to an acquisition, we must evaluate goodwill and acquisition-related intangible assets for impairment. When such assets are found to be impaired, they will be written down to estimated fair value, with a charge against earnings.

***The price of our common stock may fluctuate significantly.***

The price of our common stock is volatile and may fluctuate significantly. There can be no assurance as to the prices at which our common stock will trade or that an active trading market in our common stock will be sustained in the future. The market price at which our common stock trades may be influenced by many factors, including:



our operating and financial performance and prospects, including our ability to achieve profitability within the forecasted time period;

**Table of Contents**

the depth and liquidity of the market for our common stock;

investor perception of us and the industry in which we operate;

the level of research coverage of our common stock;

changes in earnings estimates or buy/sell recommendations by analysts;

general financial and other market conditions; and

domestic and international economic conditions.

In addition, public stock markets have experienced, and may in the future experience, 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. If our common stock trades below \$1.00 for 30 consecutive trading days, or if we otherwise do not meet the requirements for continued quotation on the Nasdaq Stock Market, our common stock could be delisted, which would adversely affect the ability of investors to sell shares of our common stock and could otherwise adversely affect our business.

***Substantial sales of the shares of our common stock issuable upon exercise of the warrant issued to Conexant could adversely affect our stock price or our ability to raise additional financing in the public capital markets.***

Conexant holds a warrant to acquire 30 million shares of our common stock at a price of \$3.408 per share, exercisable through June 27, 2013, representing approximately 17% of our outstanding common stock on a fully diluted basis. The warrant may be transferred or sold in whole or part at any time. If Conexant sells the warrants or if Conexant or a transferee of the warrants exercises the warrants and sells a substantial number of shares of our common stock in the future, or if investors perceive that these sales may occur, the market price of our common stock could decline or market demand for our common stock could be sharply reduced and our ability to raise additional financing by issuing equity or equity-based securities in the public capital markets could be adversely affected.

***Antidilution and other provisions in the warrant issued to Conexant may also adversely affect our stock price or our ability to raise additional financing.***

The warrant issued to Conexant contains antidilution provisions that provide for adjustment of the warrant's exercise price, and the number of shares issuable under the warrant, upon the occurrence of certain events. If we issue, or are deemed to have issued, shares of our common stock, or securities convertible into our common stock, at prices below the current market price of our common stock (as defined in the warrants) at the time of the issuance of such securities, the warrant's exercise price will be reduced and the number of shares issuable under the warrant will be increased. The amount of such adjustment, if any, will be determined pursuant to a formula specified in the warrant and will depend on the number of shares issued, the offering price and the current market price of our common stock at the time of the issuance of such securities. Adjustments to the warrant pursuant to these antidilution provisions may result in significant dilution to the interests of our existing stockholders and may adversely affect the market price of our common stock. The antidilution provisions may also limit our ability to obtain additional financing on terms favorable to us.

Moreover, we may not realize any cash proceeds from the exercise of the warrant held by Conexant. A holder of the warrant may opt for a cashless exercise of all or part of the warrant. In a cashless exercise, the holder of the warrant would make no cash payment to us, and would receive a number of shares of our common stock having an aggregate value equal to the excess of the then-current market price of the shares of our common stock issuable upon exercise of the warrant over the exercise price of the warrant. Such an issuance of common stock would be immediately dilutive to the interests of other stockholders.

***Some of our directors and executive officers may have potential conflicts of interest because of their positions with Conexant or their ownership of Conexant common stock.***

Some of our directors are Conexant directors, and our non-executive chairman of the board is chairman of the board and chief executive officer of Conexant. Several of our directors and executive officers own Conexant common

**Table of Contents**

stock and hold options to purchase Conexant common stock. Service on our board of directors and as a director or officer of Conexant, or ownership of Conexant common stock by our directors and executive officers, could create, or appear to create, potential conflicts of interest when directors and officers are faced with decisions that could have different implications for us and Conexant. For example, potential conflicts could arise in connection with decisions involving the warrants to purchase our common stock issued to Conexant, or other agreements entered into between us and Conexant in connection with the distribution.

Our restated certificate of incorporation includes provisions relating to the allocation of business opportunities that may be suitable for both us and Conexant based on the relationship to the companies of the individual to whom the opportunity is presented and the method by which it was presented and also includes provisions limiting challenges to the enforceability of contracts between us and Conexant.

We may have difficulty resolving any potential conflicts of interest with Conexant, and even if we do, the resolution may be less favorable than if we were dealing with an entirely unrelated third party.

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

Our restated certificate of incorporation, our amended bylaws, our rights agreement 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 amended bylaws 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 stockholders;

a prohibition on stockholder action by written consent;

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

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 amended bylaws;

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

a fair price provision.

Our rights agreement gives our stockholders 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 amended bylaws, Section 203 of the Delaware General Corporation Law generally provides that a corporation shall not engage in any business combination with any interested stockholder during the three-year period following the time that such stockholder becomes an interested stockholder, unless a majority of the directors then in office approves either the business combination or the transaction that results in the stockholder becoming an interested stockholder or specified stockholder approval requirements are met.

**Table of Contents**

**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

Our cash and cash equivalents consist of demand deposits and highly-liquid money market funds. Our marketable securities consist of auction rate securities whose interest rates reset periodically (generally every seven or twenty-eight days) and U.S. Treasury securities having maturities of less than eighteen months. Our main investment objectives are the preservation of investment capital and the maximization of after-tax returns on our investment portfolio. Consequently, we invest in the securities of high-credit-quality issuers and limit the amount of our credit exposure to any one issuer. We do not use derivative instruments for speculative or investment purposes.

*Interest Rate Risk*

Our cash and cash equivalents and marketable securities are not subject to significant interest rate risk due to the short maturities or variable interest rate characteristics of these instruments. As of June 30, 2005, the carrying value of our cash and cash equivalents and marketable securities approximates fair value.

Our long-term debt consists of convertible senior notes which bear interest at a fixed rate of 3.75%. Consequently, our results of operations and cash flows are not subject to any significant interest rate risk relating to our long-term debt.

*Foreign Exchange Risk*

We transact business in various foreign currencies and we face foreign exchange risk on assets and liabilities that are denominated in foreign currencies. The majority of our foreign exchange risks are not hedged; however, from time to time, we may utilize foreign currency forward exchange contracts to hedge a portion of our exposure to foreign exchange risk. These hedging transactions are intended to offset the gains and losses we experience on foreign currency transactions with gains and losses on the forward contracts, so as to mitigate our overall risk of foreign exchange gains and losses. We do not enter into forward contracts for speculative or trading purposes. At June 30, 2005, we held no foreign currency forward exchange contracts. Based on our overall currency rate exposure at June 30, 2005, a 10 percent change in currency rates would not have a material effect on our consolidated financial position, results of operations or cash flows.

**ITEM 4. CONTROLS AND PROCEDURES**

Under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and its Chief Financial Officer, the Company carried out an evaluation of the effectiveness as of June 30, 2005 of the design and operation of its disclosure controls and procedures, which are defined under Securities and Exchange Commission rules as controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files under the Exchange Act is recorded, processed, summarized and reported within required time periods. Based upon that evaluation, the Company's Chief Executive Officer and its Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective as of the end of the period covered by this Quarterly Report to timely alert them to material information relating to the Company required to be included in the Company's Exchange Act filings. There were no changes in the Company's internal control over financial reporting during the fiscal quarter ended June 30, 2005 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 5. OTHER INFORMATION**

The following disclosure would otherwise be filed on Form 8-K under the heading Item 1.01. Entry Into a Material Definitive Agreement :

On August 4, 2005, the Company's board of directors approved amendments to the Mindspeed Technologies, Inc. 2003 Employee Stock Purchase Plan (the "ESPP") and related Offering document and the Mindspeed Technologies, Inc. 2003 Non-Qualified Employee Stock Purchase Plan (the "Non-Qualified ESPP" and, together with the ESPP, the "Plans") and related Offering document.

The Plans and related Offering documents were amended to reflect: (i) the appointment of Fidelity Stock Plan Services as Agent for the Plans; (ii) the change of the primary trading market for the Company's Common Stock from the American Stock Exchange to the Nasdaq National Market; (iii) the Company's ability to establish the discount for the purchase of shares under the Non-Qualified ESPP at less than 15% (consistent with the terms of the ESPP); (iv) that each Offering will be six months in duration commencing on the first Trading Day (as defined in the Plans) of each September and March (beginning with September 1, 2005) and ending on the last Trading Day of the next February and August, respectively; (v) that the purchase price of the shares of Company Common Stock to be purchased under the Plans will be 95% of the Fair Market Value (as defined in the Plans) of the Company Common Stock on the last Trading Day of each Offering; and (vi) certain other ancillary administrative matters.

**Table of Contents**

**ITEM 6. EXHIBITS**

- 3.1 Restated Certificate of Incorporation of Registrant, filed as Exhibit 4.1 to Registrant's Registration Statement on Form S-3 (Registration Statement No. 333-106146), is incorporated herein by reference.
- 3.2 Bylaws of Registrant, as amended, filed as Exhibit 3.1 to Registrant's Quarterly Report on Form 10-Q for the quarter ended March 31, 2004, is incorporated herein by reference.
- 4.1 Specimen certificate for Mindspeed Common Stock, par value \$.01 per share, filed as Exhibit 4.1 to Registrant's Registration Statement on Form 10 (File No. 1-31650), is incorporated herein by reference.
- 4.2 Rights Agreement dated as of June 26, 2003 by and between Mindspeed Technologies, Inc. and Mellon Investor Services LLC, as Rights Agent, filed as Exhibit 4.1 to Registrant's Current Report on Form 8-K dated July 1, 2003, is incorporated herein by reference.
- 4.3 Indenture, dated as of December 8, 2004, between the Registrant and Wells Fargo Bank, N.A., filed as Exhibit 4.1 to the Registrant's Current Report on Form 8-K dated December 8, 2004, is incorporated herein by reference.
- 4.4 Form of 3.75% Convertible Senior Notes due 2009, attached as Exhibit A to the Indenture (Exhibit 4.3 hereto), is incorporated herein by reference.
- 4.5 Registration Rights Agreement, dated December 8, 2004, between the Registrant and Lehman Brothers Inc., filed as Exhibit 4.3 to the Registrant's Current Report on Form 8-K dated December 8, 2004, is incorporated herein by reference.
- 4.6 First Amendment to Rights Agreement, dated as of December 6, 2004, between the Registrant and Mellon Investor Services LLC, filed as Exhibit 4.4 to the Registrant's Current Report on Form 8-K dated December 8, 2004, is incorporated herein by reference.
- \*10.1 Mindspeed Technologies, Inc. 2003 Employee Stock Purchase Plan.
- \*10.2 Mindspeed Technologies, Inc. 2003 Non-Qualified Employee Stock Purchase Plan.
- \*10.3 Schedule identifying agreements substantially identical to the Form of Employment Agreement filed as Exhibit 10.8.1 to the Company's Registration Statement on Form 10 (File No. 1-31650).
- \*10.4 Form of Stock Option Award under the Mindspeed Technologies, Inc. 2003 Long-Term Incentives Plan.
- \*10.5 Stock Option Terms and Conditions under the Mindspeed Technologies, Inc. 2003 Long-Term Incentives Plan.
- \*10.6 Form of Restricted Stock Award under the Mindspeed Technologies, Inc. 2003 Long-Term Incentives Plan.
- \*10.7 Form of Stock Option Award under the Mindspeed Technologies, Inc. Directors Stock Plan.
- \*10.8 Stock Option Terms and Conditions under the Mindspeed Technologies, Inc. Directors Stock Plan.
- \*10.9 Mindspeed Technologies, Inc. Retirement Savings Plan.

\*10.10 Mindspeed Technologies, Inc. Deferred Compensation Plan.

12.1 Statement re: Computation of Ratios.

31.1 Certifications of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

31.2 Certifications of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

32.1 Certification of Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

32.2 Certification of Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

\* Management  
contract or  
compensatory  
plan or  
arrangement.



**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.

MINDSPEED TECHNOLOGIES, INC.  
(Registrant)

Date: August 9, 2005

By /s/ Simon Biddiscombe

Simon Biddiscombe  
Senior Vice President, Chief Financial Officer  
Secretary and Treasurer  
(principal financial officer)

38

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**Table of Contents**

**EXHIBIT INDEX**

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