CONEXANT SYSTEMS INC
Form 10-Q
August 09, 2005

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

FORM 10-Q

þ **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

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

Commission file number: 000-24923

CONEXANT SYSTEMS, INC.

(Exact name of registrant as specified in its charter)

Delaware	**25-1799439**
(State of incorporation)	(I.R.S. Employer Identification No.)

4000 MacArthur Boulevard
Newport Beach, California 92660-3095
(Address of principal executive offices) (Zip code)
(949) 483-4600
(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.
Yes þ No o

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

Number of shares of registrant s common stock outstanding as of July 29, 2005 was 473,411,213.

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

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CAUTIONARY STATEMENT

Safe Harbor Statement under the Private Securities Litigation Reform Act of 1995: This Quarterly Report on Form 10-Q includes forward-looking statements intended to qualify for the safe harbor from liability established by the Private Securities Litigation Reform Act of 1995. These forward-looking statements generally can be identified by phrases such as Conexant or the company believes, expects, anticipates, foresees, forecasts, estimates or othe or phrases of similar import. Similarly, statements in this Quarterly Report on Form 10-Q that describe the company s business strategy, outlook, objectives, plans, intentions or goals also are forward-looking statements. All such forward-looking statements are subject to certain risks and uncertainties that could cause actual results to differ materially from those in forward-looking statements.

Conexant s future results will be affected by the implementation of new accounting rules related to the expensing of stock options commencing in fiscal 2006. Other risks and uncertainties include, but are not limited to: general economic and political conditions and conditions in the markets the company addresses; the substantial losses the company has incurred recently; the cyclical nature of the semiconductor industry and the markets addressed by the company s and its customers products; continuing volatility in the technology sector and the semiconductor industry; demand for and market acceptance of new and existing products; successful development of new products; the timing of new product introductions and product quality; the company s ability to anticipate trends and develop products for which there will be market demand; the availability of manufacturing capacity; pricing pressures and other competitive factors; changes in product mix; product obsolescence; the ability of the company s customers to manage inventory; the ability to develop and implement new technologies and to obtain protection for the related intellectual property; the uncertainties of litigation and the demands it may place on the time and attention of company management; and possible disruptions in commerce related to terrorist activity or armed conflict, as well as other risks and uncertainties, including those detailed from time to time in our Securities and Exchange Commission filings. These forward-looking statements are made only as of the date hereof. We undertake no obligation to update or revise the forward-looking statements, whether as a result of new information, future events or otherwise.

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PART I. FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS

CONEXANT SYSTEMS, INC.
Consolidated Condensed Balance Sheets
(unaudited, in thousands, except per share amounts)

	June 30, 2005	September 30, 2004
ASSETS		
Current assets:		
Cash and cash equivalents	$ 160,496	$ 139,031
Short-term investments	153,286	163,040
Receivables, net of allowance of $3,955 and $5,974 at June 30, 2005 and September 30, 2004, respectively	82,345	185,037
Inventories	103,491	194,754
Mindspeed warrant-current portion		3,599
Other current assets	19,745	20,768
Total current assets	519,363	706,229
Property, plant and equipment, net	50,333	55,741
Goodwill	718,335	708,544
Intangible assets, net	114,628	135,241
Mindspeed warrant	11,242	23,000
Marketable securities	72,024	137,604
Other assets	105,871	114,163
Total assets	$ 1,591,796	$ 1,880,522
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 94,655	$ 141,533
Accrued compensation and benefits	38,149	40,423
Restructuring and reorganization liabilities	25,278	22,427
Other current liabilities	58,329	67,044
Current portion of convertible subordinated notes	196,825	
Total current liabilities	413,236	271,427
Convertible subordinated notes, net of current portion	515,000	711,825
Other liabilities	97,653	68,883
Total liabilities	1,025,889	1,052,135
Commitments and contingencies		
Shareholders equity:		

Preferred and junior preferred stock		
Common stock, $0.01 par value: 1,000,000 shares authorized; 472,471 and 469,441 shares issued, and 471,288 shares and 468,257 shares outstanding at June 30, 2005 and September 30, 2004, respectively	4,725	4,694
Treasury stock: 1,184 shares at cost	(5,584)	(5,584)
Additional paid-in capital	4,654,913	4,648,325
Accumulated deficit	(4,103,247)	(3,877,176)
Accumulated other comprehensive income	30,945	82,551
Notes receivable from stock sales	(336)	(576)
Unearned compensation	(15,509)	(23,847)
Total shareholders equity	565,907	828,387
Total liabilities and shareholders equity	$ 1,591,796	$ 1,880,522

See accompanying notes to consolidated condensed financial statements.

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

	Three months ended June 30,		Nine months ended June 30,	
	2005	**2004**	**2005**	**2004**
Net revenues	$197,464	$267,617	$ 507,823	$ 688,731
Cost of goods sold	122,430	155,136	365,661	395,448
Gross margin	75,034	112,481	142,162	293,283
Operating expenses:				
Research and development [(1)]	66,282	74,317	209,362	167,205
Selling, general and administrative [(1)]	31,081	36,371	89,449	89,782
Amortization of intangible assets	7,969	7,956	24,402	12,564
In-process research and development				160,818
Special charges	8,409	8,294	41,262	14,413
Total operating expenses	113,741	126,938	364,475	444,782
Operating loss	(38,707)	(14,457)	(222,313)	(151,499)
Interest expense	8,396	8,373	25,290	22,322
Other (income) expense, net	(15,610)	47,935	(23,367)	(1,031)
Loss before income taxes	(31,493)	(70,765)	(224,236)	(172,790)
Provision for income taxes	673	661	1,835	1,368
Net loss	$ (32,166)	$ (71,426)	$(226,071)	$(174,158)
Net loss per share basic and diluted	$ (0.07)	$ (0.15)	$ (0.48)	$ (0.48)
Number of shares used in per share computation	471,247	463,804	469,935	363,654

(1) Non-cash employee stock compensation is included in the above captions as follows:

	Three months ended June 30,		**Nine months ended June 30,**	
	2005	**2004**	**2005**	**2004**
Research and development	$2,275	$2,237	$6,795	$3,131
Selling, general and administrative	744	743	2,232	1,029

See accompanying notes to consolidated condensed financial statements.

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

	Nine months ended June 30, 2005	Nine months ended June 30, 2004
Cash flows from operating activities:		
Net loss	$(226,071)	$(174,158)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities, net of effects of acquisitions:		
Depreciation	14,054	11,337
Amortization of intangible assets	24,402	12,564
In-process research and development		160,818
Reduction of provision for bad debt	(1,543)	
Inventory provisions	50,150	6,046
Decrease in fair value of Skyworks note and Mindspeed warrant	14,804	44,671
Equity in losses (earnings) of equity method investees	8,587	(12,750)
Gain on sale of equity securities, investments and other assets	(42,310)	(27,017)
Stock compensation, option modification charges and other	9,027	6,268
Other non-cash items, net	(299)	6,200
Changes in assets and liabilities:		
Receivables	104,386	(42,174)
Inventories	43,324	(18,631)
Accounts payable	(47,535)	30,131
Agere patent litigation settlement	(8,000)	
Special charges and other restructuring related items, net of $45.5 million and $10.9 million of payments, respectively	(4,241)	3,542
Accrued expenses and other current liabilities	7,947	5,400
Other	(5,348)	(10,589)
Net cash provided by (used in) operating activities	(58,666)	1,658
Cash flows from investing activities:		
Cash paid for acquisitions, net of cash acquired	(18,817)	24,752
Sales of equity securities, investments and other assets	44,360	31,580
Purchases of marketable securities	(45,244)	(67,816)
Sales and maturities of other marketable securities	68,831	38,384
Net proceeds from purchase and sale-leaseback and other	49,071	
Capital expenditures	(16,426)	(13,922)
Payment of merger costs		(29,764)
Payment of deferred purchase consideration		(4,000)
Investments in businesses	(2,580)	(2,619)
Net cash provided by (used in) investing activities	79,195	(23,405)
Cash flows from financing activities:		

Proceeds from exercise of stock options	740	24,110
Repayment of notes receivable from stock sales	196	
Net cash provided by financing activities	936	24,110
Net increase in cash and cash equivalents	21,465	2,363
Cash and cash equivalents at beginning of period	139,031	76,186
Cash and cash equivalents at end of period	$ 160,496	$ 78,549

See accompanying notes to consolidated condensed financial statements.

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

1. Basis of Presentation and Significant Accounting Policies

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

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

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

Fiscal Periods For presentation purposes, references made to the periods ended June 30, 2004 and 2005, relate to the actual fiscal 2004 third quarter ended July 2, 2004 and the actual third fiscal quarter of 2005 ended July 1, 2005, respectively.

Supplemental Cash Flow Information Cash paid for interest was $20.0 million and $16.6 million for the nine months ended June 30, 2005 and 2004, respectively. Cash paid for income taxes for the nine months ended June 30, 2005 and 2004 was $1.9 million and $0.2 million, respectively.

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

Conexant has more than 20 distributor customers for whom revenue is recognized upon its shipment of product to them, as the contractual terms provide for no or limited rights of return. During the three months ended December 31, 2004, the Company determined that it was unable to enforce its contractual terms with three distribution customers. As a result, from October 1, 2004, the Company has deferred the recognition of revenue on sales to these three distributors until the purchased products are sold by the distributors to a third party.

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

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

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

(weighted-average number of shares, in thousands)	Three months ended June 30,		Nine months ended June 30,	
	2005	2004	2005	2004
Stock options and warrants (under the treasury stock method)	479	21,734	1,284	24,239
4.25% Convertible Subordinated Notes due 2006	7,364	7,364	7,364	7,364
5.25% Convertible Subordinated Notes due 2006	5,840	5,840	5,840	2,695
4.00% Convertible Subordinated Notes due 2007	12,137	12,137	12,137	12,137
Restricted stock	5	10	6	15

Stock-Based Compensation The Company accounts for employee stock-based compensation in accordance with the provisions of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB 25) and therefore no compensation expense has been recognized for fixed stock option plans as options are granted at fair market value on the date of grant. The Company also has an employee stock purchase plan for all eligible employees. The Company has adopted the pro forma disclosure provisions of SFAS No. 123, Accounting for Stock-Based Compensation, as amended by SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure. Had stock-based compensation been determined based on the fair value at the grant date for awards consistent with the provisions of SFAS No. 123, the Company s pro forma net loss and pro forma net loss per share would have been the amounts indicated below (in thousands, except per share amounts):

	Three months ended June 30,		Nine months ended June 30,	
	2005	2004	2005	2004
Net loss, as reported	$(32,166)	$(71,426)	$(226,071)	$(174,158)
Add: expense determined under fair value accounting included in net loss, as reported	3,019	2,980	9,027	4,160
Deduct: total expense determined under fair value accounting for all awards	(14,952)	(15,946)	(49,494)	(38,505)
Pro forma net loss	$(44,099)	$(84,392)	$(266,538)	$(208,503)
Net loss per share basic and diluted, as reported	$ (0.07)	$ (0.15)	$ (0.48)	$ (0.48)
Pro forma net loss per share basic and diluted	$ (0.09)	$ (0.18)	$ (0.57)	$ (0.48)

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

Three months ended March 31,		Nine months ended June 30,	
2005	2004	2005	2004

Risk-free interest rate	3.77%	3.93%	3.85%	3.33%
Expected volatility	86%	97%	86%	97%
Dividend yield				
Expected life (years)	5.0	4.5	4.9	4.1
Weighted-average fair value of options granted	$1.02	$3.63	$1.03	$5.04

The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions, including the expected stock price volatility. Because awards held by employees and

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directors have characteristics significantly different from those of traded options, and because changes in the subjective input assumptions can materially affect the fair value estimate, in the opinion of management, the existing models do not necessarily provide a reliable single measure of the fair value of these options.

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

Shipping and Handling In accordance with EITF 00-10, Accounting for Shipping and Handling Fees and Costs , the Company includes shipping and handling fees billed to customers in net revenues. Amounts incurred by the Company for freight are included in cost of goods sold.

Recent Accounting Pronouncements In December 2004, the Financial Accounting Standards Board issued SFAS No. 123 (R), Share-Based Payment . This pronouncement amends SFAS No. 123, and supersedes APB Opinion No. 25. SFAS No. 123 (R) requires that public companies account for awards of equity instruments issued to employees under the fair value method of accounting and recognize such amounts in the statement of operations. The implementation of this statement was delayed by the Securities and Exchange Commission and will be effective beginning with the Company s first quarter of fiscal 2006. The Company expects the impact of this new pronouncement to be significant to its results of operations.

Cash, Cash Equivalents and Investments Marketable Securities The Company considers all highly liquid investments with insignificant interest rate risk and original maturities of three months or less from the date of purchase to be cash equivalents. The carrying amounts of cash and cash equivalents approximate their fair values. Short-term marketable securities consist of mutual funds, debt securities with original maturity dates between ninety days and one year, and equity securities. Long-term marketable securities consist of debt securities with original maturity dates greater than one year. The Company s investments are classified as available-for-sale, and are reported at fair value at the balance sheet date. The unrealized gains and losses are reported as a component of accumulated other comprehensive income (loss). Management determines the appropriate classification of debt securities at the time of purchase and reassesses the classification at each reporting date. Gains and losses on the sale of available-for-sale investments are determined using the specific-identification method.

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

Total cash, cash equivalents and marketable securities at June 30, 2005 and at September 30, 2004 are as follows (in thousands):

	June 30, 2005	**September 30, 2004**
Cash and cash equivalents	$160,496	$139,031
Equity securities- Skyworks Solutions, Inc. (6.2 million shares at June 30, 2005 and September 30, 2004)	46,248	61,767
Equity securities- SiRF Technology Holdings, Inc. (2.8 million and 5.9 million shares at June 30, 2005 and September 30, 2004, respectively)	48,977	87,509
Other short-term marketable securities (primarily mutual funds, domestic government agency securities and corporate debt securities)	58,061	13,764
Subtotal- short-term investments	153,286	163,040

Long-term marketable securities (primarily domestic government agency securities and corporate debt securities)	72,024	137,604
Total cash, cash equivalents and marketable securities	$385,806	$439,675

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For all investment securities, unrealized losses that are other than temporary are recognized in net income (loss). The Company does not hold these securities for speculative or trading purposes. During the three and nine months ended June 30, 2005, the Company sold shares of equity securities for cash proceeds of $32.6 million and $44.4 million, respectively, and realized gains on the sales of these securities of $31.2 million and $42.3 million, respectively.
In July 2005, the Company sold the remaining 2.8 million shares of SiRF Technology Holdings, Inc. for cash proceeds of $50.9 million and realized gains on the sales of these securities of $49.0 million.

2. Acquisitions

Fiscal 2005

Acquisition of Paxonet Communications, Inc.

On December 3, 2004, the Company acquired all of the outstanding capital stock of Paxonet Communications, Inc. (Paxonet), a privately held company headquartered in Fremont, California, with an engineering workforce primarily based in India.
The consideration for this purchase was $14.8 million in cash. Net tangible assets acquired were $0.4 million. Approximately $0.7 million of the purchase price was allocated to unearned compensation representing the intrinsic value of unvested stock options exchanged in the transaction and the remainder to identifiable intangible assets and goodwill. The unearned compensation is being amortized to expense over the four year remaining vesting period of the stock options. A total of $43,000 and $101,000 of this unearned compensation was recognized as an expense in the three and nine months ended June 30, 2005, respectively. The identifiable intangible assets of $1.4 million are being amortized on a straight-line basis over a period of two to eight years, with a weighted-average life of approximately six years. The $12.4 million in goodwill is not deductible for tax purposes.
The Company also completed an asset acquisition in the three months ended March 31, 2005 which was not material to its consolidated financial statements.
The pro forma effects of these acquisitions were not material to the Company s results of operations for fiscal 2005 or 2004.

Fiscal 2004

Acquisition of Amphion Semiconductor

On June 29, 2004, the Company purchased all the outstanding capital stock of Amphion Semiconductor Limited (Amphion), a company located in Belfast, Northern Ireland specializing in developing video compression technology. The Company completed this strategic acquisition as a complement to existing products. The consideration for this purchase was $20.0 million in cash, 600,000 shares of common stock (valued at $6.0 million) and $0.4 million in transaction costs. Net tangible assets acquired were $2.4 million. The excess of the purchase price over the net tangible assets was assigned to developed technology of $4.2 million and $19.4 million to goodwill. The developed technology will be amortized on a straight-line basis over five years. The $19.4 million in goodwill is not deductible for tax purposes.
Under the stock purchase agreement, the Company guaranteed the value of the shares issued to the former Amphion shareholders for a defined period through June 29, 2006 (subject to certain conditions and elections). The guaranty is subject to adjustment for any stock split, stock dividend, recapitalization, merger or similar transaction. In the event that the market price of the Conexant common stock does not equal or exceed $10.00 for at least five consecutive trading days during this period, Conexant would be required to make an additional payment (in cash or additional shares of common stock at Conexant s option) to former Amphion shareholders for the difference between the $10.00 and the market price per share of such shares as of specified dates. Consequently, the Company has valued the shares delivered to the former Amphion shareholders at the guaranteed value of $10.00 per share, or a

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total of $6.0 million. To the extent the Company is required to make an additional payment under the guaranty, the payment will not increase the total purchase price.

The terms of this acquisition include provisions under which the former shareholders of Amphion could receive additional consideration of up to $3.0 million through December 31, 2005 if certain technology milestones are achieved. This contingent consideration has not been included in the purchase price allocation and if earned, such amounts will be capitalized as an addition to goodwill.

Merger with GlobespanVirata, Inc.

On February 27, 2004, the Company completed its merger with GlobespanVirata, with GlobespanVirata becoming a wholly-owned subsidiary of the Company. In May 2004, the GlobespanVirata, Inc. subsidiary was renamed Conexant, Inc., and hereinafter will be referred to as Conexant, Inc., and the overall business combination is hereinafter referred to as the Merger.

The Merger was accounted for as a purchase and the operating results of the former GlobespanVirata have been included in the Company s operations from the closing date.

A portion of the Merger purchase price was allocated to in process research and development (IPR&D). $160.8 million was expensed upon completion of the Merger (as a charge not deductible for tax purposes) as it was determined that the underlying products had not reached technological feasibility, had no alternative uses and successful development was uncertain. The Company identified and valued IPR&D projects relating to the development of DSL and wireless networking products. The DSL projects represented 70% of the total IPR&D acquired. The estimated costs to complete for the DSL and wireless networking projects were approximately $14.1 million and $6.2 million, respectively. The fair values assigned to these projects were based on the income approach and used projected cash flows which were discounted at a rate of 19%. The discount rate was derived from a weighted-average cost of capital analysis, adjusted upwards to reflect additional risks inherent in the development process, including the probability of achieving technological success and market acceptance. Each of the IPR&D projects was analyzed considering technological innovations, the existence and utilization of core technology, the complexity, costs and time to complete the remaining development efforts, and stage of completion. The discount rate reflects the stage of completion and other risks inherent in the projects. The material risks associated with the incomplete projects are the ability to complete the items within the outlined timeframes and within the allocated cost guidelines, and ultimately to sell the products to end-users. As of June 30, 2005, the DSL related IPR&D projects were approximately 35% complete, 60% are expected to be completed by the end of calendar 2005, and 5% have been abandoned due to product roadmap and market changes. The wireless networking related IPR&D projects are approximately 50% complete and 50% are expected to be completed by the end of calendar 2005. Completion costs to date on all projects have been consistent with estimates made at the time of the Merger. However, revenue projections for the sale of DSL and wireless networking products have declined since the time of the Merger. See Net Revenues portion in Results of Operations section of Management s Discussion and Analysis for further discussion.

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CONEXANT SYSTEMS, INC.
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(unaudited)

3. Supplemental Financial Statement Data

Marketable Securities

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

Short-term investments (in thousands):	Amortized Cost	Gross Unrealized Holding Gains	Gross Unrealized Holding Losses	Fair Value
June 30, 2005:				
Corporate debt securities	$ 24,015	$	$ (3)	$ 24,012
Domestic government agency securities	34,051		(2)	34,049
Equity securities	54,459	47,042	(6,276)	95,225
	$112,525	$47,042	$(6,281)	$153,286
September 30, 2004:				
Mutual funds	$ 10,837	$	$ (125)	$ 10,712
Corporate debt securities	2,274		(3)	2,271
Equity securities	56,524	93,533		150,057
	$ 69,635	$93,533	$ (128)	$163,040

During the three and nine months ended June 30, 2005, the Company sold shares of equity securities for cash proceeds of $32.6 million and $44.4 million, respectively. The gains on sales of these securities were $31.2 million and $42.3 million, respectively.

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

Long-term investments (in thousands):	Amortized Cost	Gross Unrealized Holding Gains	Gross Unrealized Holding Losses	Fair Value
June 30, 2005:				
Domestic government agency securities	$ 41,974	$	$ (232)	$ 41,742
Corporate debt securities	30,564	1	(283)	30,282
	$ 72,538	$ 1	$ (515)	$ 72,024
September 30, 2004:				
Domestic government agency securities	$105,956	$	$ (800)	$105,156
Corporate debt securities	32,595		(147)	32,448
	$138,551	$	$ (947)	$137,604

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

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Inventories

Inventories consist of the following (in thousands):

	June 30, 2005	September 30, 2004
Work-in-process	$ 62,000	$ 99,226
Finished goods.	41,491	95,528
	$103,491	$194,754

At June 30, 2005 and September 30, 2004, inventories are net of $49.8 million and $23.3 million, respectively, of allowances for excess and obsolete (E&O) inventories. In addition, at June 30, 2005, inventories are net of $7.0 million in lower of cost or market reserves. Activity in the E&O inventory reserves for the three and nine months ended June 30, 2005 was as follows:

	Three months ended June 30, 2005	Nine months ended June 30, 2005
E&O reserves, beginning of period	$ 53,302	$ 23,319
Additions	2,131	31,296
Release upon sales of product	(1,298)	(2,299)
Scrap	(3,460)	(5,502)
Standards adjustments and other	(864)	2,997
E&O reserves, end of period	$ 49,811	$ 49,811

The Company has created an action plan at a product line level to scrap approximately 30% of the E&O products and is still in the process of evaluating the remaining reserved products. It is possible that some of these reserved products will be sold which will benefit gross margin in the period sold. During the three and nine months ended June 30, 2005, the Company sold $1.3 million and $2.3 million, respectively, of reserved products which benefited gross margin in the associated period.

The Company s products are used by communications electronics OEMs that have designed the products into communications equipment. For many of the products, the Company gains design wins through a lengthy sales cycle, which often includes providing technical support to the OEM customer. Moreover, once a customer has designed a particular supplier s components into a product, substituting another supplier s components often requires substantial design changes which involve significant cost, time, effort and risk. In the event of the loss of business from existing OEM customers, the Company may be unable to secure new customers for the 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, the Company generally will be unable to sell the excess inventories to others, and the estimated realizable value of such inventories is generally zero.

On a quarterly basis, the Company assesses the net realizable value of its inventories. When the estimated average selling price, plus costs to sell the inventory falls below the inventory cost, inventory is adjusted to its current estimated market value. During the nine months ended June 30, 2005, the Company recorded $18.9 million in inventory charges to adjust certain Wireless Networking products to their estimated market value. Increases to this inventory reserve may be required based upon actual average selling prices and changes to current estimates, which

would impact gross margin percentage in future periods. Activity in the lower of cost or market (LCM) inventory reserves for the three and nine months ended June 30, 2005 was as follows:

	Three months ended June 30, 2005	**Nine months ended June 30, 2005**
LCM reserves, beginning of period	$ 11,093	$
Additions		18,854
Release upon sales of product	(1,488)	(5,370)
Scrap		
Standards adjustments and other	(2,588)	(6,467)
LCM reserves, end of period	$ 7,017	$ 7,017

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Goodwill

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

Goodwill, September 30, 2004	$708,544
Acquisitions	16,097
Adjustments to prior purchase price allocation (1)	(6,306)
Goodwill, June 30, 2005	$718,335

(1) In the Merger, the Company acquired a reserve for income tax contingencies for foreign income tax matters which arose due to items recorded in the income tax returns of the former GlobespanVirata subsidiaries. In the quarter ended December 31, 2004, a portion of this income tax contingency was settled with the taxing authorities, and as a result, the amount of the liability in excess of the settlement amount, or $5.4 million, was reduced with a corresponding reduction to goodwill. In addition, in the quarter ended March 31, 2005,

as a result of subsequent decisions on the consolidation of facilities, the Company reduced certain restructuring and other facilities reserves established at the time of the Merger by a net of $0.9 million. A corresponding reduction was made to goodwill.

Intangible Assets

Intangible assets consist of the following (in thousands):

	June 30, 2005			September 30, 2004		
	Gross Asset	Accumulated Amortization	Net	Gross Asset	Accumulated Amortization	Net
Developed technology	$146,146	$(47,033)	$ 99,113	$145,946	$(25,359)	$120,587
Customer base	4,660	(1,549)	3,111	2,050	(847)	1,203
Other intangible assets	21,888	(9,484)	12,404	20,908	(7,457)	13,451
	$172,694	$(58,066)	$114,628	$168,904	$(33,663)	$135,241

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

	Remainder of 2005	2006	2007	2008	2009	Thereafter
Amortization expense	$ 7,918	$30,701	$29,801	$29,334	$13,831	$3,043

Mindspeed Warrant

The Company has a warrant to purchase 30 million shares of Mindspeed Technologies, Inc. (Mindspeed) common stock at an exercise price of $3.408 per share through June 2013. The Company accounts for the Mindspeed warrant as a derivative instrument, and changes in the fair value of the warrant are included in other (income) expense, net each period. At June 30, 2005, the aggregate fair value of the Mindspeed warrant included on the accompanying consolidated condensed balance sheet was $11.2 million. The warrant was valued using a Black-Scholes model with terms for portions of the warrant varying from 1 to 5 years, expected volatility of 90%, a risk-free interest rate of 3.2% and no dividend yield. Given current market conditions, the Company has determined that at this time, it does not have the ability to liquidate a portion of the warrant in the next twelve months. Consequently, all amounts are reflected as long-term on the accompanying consolidated condensed balance sheet.

The valuation of this derivative instrument is subjective, and option valuation models require the input of highly subjective assumptions, including the expected stock price volatility. Changes in these assumptions can materially

affect the fair value estimate. The Company could, at any point in time, ultimately realize amounts significantly different than the carrying value.

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Convertible Subordinated Notes

At September 30, 2004 and June 30, 2005, the components of convertible subordinated notes are as follows (in thousands):

4.00% Convertible Subordinated Notes due February 2007 with a conversion price of $42.43	$ 515,000
4.25% Convertible Subordinated Notes due May 2006 with a conversion price of $9.08	66,825
5.25% Convertible Subordinated Notes due May 2006 with a conversion price of $22.26	130,000
Total	711,825
Less, current portion of convertible subordinated notes	(196,825)
Long- term portion of convertible subordinated notes	$ 515,000

Purchase and Sale-Leaseback

In March 2005, the Company completed the purchase and sale-leaseback of two buildings in Newport Beach, California. In August 2004, the Company exercised its approximate $60.0 million purchase option on these buildings under its then existing lease agreement. Concurrent with the payment of the $60.0 million purchase option in March 2005, the Company sold the buildings to a third party for $110.0 million. Net cash proceeds from this transaction, after closing costs of approximately $1.0 million, were approximately $49.0 million. The net deferred gain on the sale was $43.6 million, excluding $5.4 million of leasehold improvements and other property associated with these buildings.

The Company will continue to occupy one of the buildings under a ten year lease. The other building will be leased back by the Company for a period of 39 months, and Mindspeed will continue to occupy that space as a subtenant for the entire term of the lease. The net gain on the sale of $43.6 million has been deferred and is included in other long-term liabilities on the accompanying consolidated condensed balance sheet, and will be recognized as a reduction to rent expense ratably over the terms of the respective leases.

Other (Income) Expense, Net

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

	Three months ended		Nine months ended	
	June 30, 2005	**June 30, 2004**	**June 30, 2005**	**June 30, 2004**
Investment and interest income	$ (2,182)	$ (1,404)	$ (3,956)	$ (6,703)
Decrease in fair value of the conversion right under the Skyworks 15% convertible senior subordinated notes		17,837		6,292
Decrease in fair value of the Mindspeed warrant	16,085	60,924	14,804	38,379
Equity in (earnings) losses of equity method investees	2,127	(1,934)	8,587	(12,750)
Gains on sales of equity securities, investments and assets	(31,198)	(27,107)	(42,310)	(27,017)
Other	(442)	(471)	(492)	768
Other (income) expense, net	$(15,610)	$ 47,935	$(23,367)	$ (1,031)

During the three and nine months ended June 30, 2005, the Company sold shares of equity securities for cash proceeds of $32.6 million and $44.4 million, respectively. The gain on sales of these securities was $31.2 million and $42.3 million, respectively.

During the nine months ended June 30, 2004, an unrelated party repaid a $30.0 million note issued in connection with a previous equity investment in Jazz Semiconductor, Inc., in which the Company owns a 38% interest. In accordance with Staff Accounting Bulletin No. 51, the Company recognized an $11.4 million gain upon the payment of this note, which is included in equity in earnings of equity method investees.

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4. Skyworks Notes

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

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

5. Commitments and Contingencies

Legal Matters

Certain claims have been asserted against the Company, including claims alleging the use of the intellectual property rights of others in certain of the Company s products. The resolution of these matters may entail the negotiation of a license agreement, a settlement, or the adjudication of such claims through arbitration or litigation. See Note 7-Special Charges. The outcome of litigation cannot be predicted with certainty and some lawsuits, claims or proceedings may be disposed of unfavorably to the Company. Many intellectual property disputes have a risk of injunctive relief and there can be no assurance that a license will be granted. Injunctive relief could have a material adverse effect on the financial condition or results of operations of the Company. Based on its evaluation of matters which are pending or asserted and taking into account the Company s reserves for such matters, management believes the disposition of such matters will not have a material adverse effect on the financial condition, results of operations, or cash flows of the Company.

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

have a material adverse impact on the Company s financial condition, results of operations, or cash flows.

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Texas Instruments, Inc. The Company s Conexant, Inc. subsidiary has been involved in a dispute with Texas Instruments, Inc. (Texas Instruments) over a group of patents (and related foreign patents) that Texas Instruments alleges are essential to certain industry standards for implementing ADSL technology. On June 12, 2003, Conexant, Inc. filed a complaint against Texas Instruments, Stanford University and its Board of Trustees, and Stanford University OTL, LLC (collectively, the Defendants) in the U.S. District Court of New Jersey. The complaint asserts, among other things, that the Defendants have violated the antitrust laws by creating an illegal patent pool, by manipulating the patent process and by abusing the process for setting industry standards related to ADSL technology. The complaint also asserts that the Defendants patents relating to ADSL are unenforceable, invalid and/or not infringed by Conexant, Inc. products. Conexant, Inc. is seeking, among other things, (i) a finding that the Defendants have violated the federal antitrust laws and treble damages based upon such a finding, (ii) an injunction prohibiting the Defendants from engaging in anticompetitive practices, (iii) a declaratory judgment that the claims of the Defendants ADSL patents are invalid, unenforceable, void, and/or not infringed by Conexant, Inc. and (iv) an injunction prohibiting the Defendants from pursuing patent litigation against Conexant, Inc. and its customers. On August 11, 2003 and September 9, 2003, the Defendants answered the complaint, denied Conexant, Inc. s claims and filed counterclaims alleging that Conexant, Inc. has infringed certain of their ADSL patents. In addition to other relief, the Defendants are seeking to collect damages for alleged past infringement and to enjoin Conexant, Inc. from continuing to use the Defendant s ADSL patents. Although the Company believes that Conexant, Inc. has strong arguments in favor of its position in this dispute, it can give no assurance that Conexant, Inc. will prevail on any of these grounds in litigation. If any such litigation is adversely resolved, Conexant, Inc. could be held responsible for the payment of damages and/or future royalties and/or have the sale of certain of Conexant, Inc. products stopped by an injunction, any of which could have a material adverse effect on the Company s business, financial condition and results of operations.

Class Action Suits. In December 2004 and January 2005, the Company and certain current and former officers were named as defendants in several complaints filed on behalf of all persons who purchased Company common stock during a specified class period. These suits were filed in the U.S. District Court of New Jersey (New Jersey cases) and the U.S. District Court for the Central District of California (California cases), alleging that the defendants violated the Securities Exchange Act of 1934 (the Exchange Act) by allegedly disseminating materially false and misleading statements and/or concealing material adverse facts. The California cases have now been consolidated with the New Jersey cases so that all of the class action suits, now known as *Witriol v. Conexant, et al.,* are being heard in the U.S. District Court of New Jersey by the same judge. The defendants believe these charges are without merit and intend to vigorously defend the litigation.

In addition, in February 2005, the Company and certain of its current and former officers and the Company s Employee Benefits Plan Committee were named as defendants in *Graden v. Conexant, et al.*, a lawsuit filed on behalf of all persons who were participants in the Company s 401(k) Plan (Plan) during a specified class period. This suit was filed in the U.S. District Court of New Jersey and alleges that the defendants breached their fiduciary duties under the Employee Retirement Income Security Act, as amended, to the Plan and the participants in the Plan. The defendants believe these charges are without merit and intend to vigorously defend the litigation.

Shareholder Derivative Suits. In January 2005, the Company and certain current and former directors and officers were named as defendants in purported shareholder derivative actions (now consolidated) in California Superior Court for the County of Orange, alleging that the defendants breached their fiduciary duties, abused control, mismanaged the Company, wasted corporate assets and unjustly enriched themselves. A similar lawsuit was filed in U.S. District Court of New Jersey in May 2005. On July 28, 2005, the court approved a stay of the action filed in California pending the outcome of the motion to dismiss in *Witriol v. Conexant, et al.* The Company has negotiated a similar agreement with the plaintiffs in the New Jersey case, which is subject to approval by the court. Pursuant to the stay agreements, in the event that the parties in the *Witriol* case engage in any negotiations, plaintiffs counsel in the derivative cases will be allowed to participate. The defendants believe the charges in theses cases are without merit and intend to vigorously

defend the litigation.

Other

The Company has been designated as a potentially responsible party and is engaged in groundwater remediation at one Superfund site located at a former silicon wafer manufacturing facility and steel fabrication plant in Parker Ford, Pennsylvania formerly occupied by the Company. In addition, the Company is engaged in remediation of groundwater contamination at its former Newport Beach, California wafer fabrication facility. Management

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currently estimates the aggregate remaining costs for these remediations to be approximately $2.9 million and has accrued for these costs as of June 30, 2005.

The Company leases certain facilities and equipment under non-cancelable operating leases which expire at various dates through 2021 and contain various provisions for rental adjustments including, in certain cases, adjustments based on increases in the Consumer Price Index. The leases generally contain renewal provisions for varying periods of time. Rental expense under operating leases was approximately $17.0 million and $15.5 million for the nine months ended June 30, 2005 and 2004, respectively.

At June 30, 2005, future minimum lease payments under operating leases, excluding any sublease income, were as follows (in thousands):

Fiscal Year	
2005 remaining 3 months	$ 8,550
2006	29,382
2007	24,732
2008	20,051
2009	17,109
Thereafter	105,750
Total future minimum lease payments	$205,574

At June 30, 2005, the Company has many sublease arrangements on operating leases for terms ranging from near term to approximately 6 years. Aggregate scheduled sublease income based on current terms is approximately $19.7 million.

The summary of future minimum lease payments includes an aggregate gross amount of $40.9 million of lease obligations that principally expire through fiscal 2021, which have been accrued for in connection with the Company s reorganization and restructuring actions (see Note 7) and previous actions taken by GlobespanVirata prior to the Merger.

At June 30, 2005, the Company is contingently liable for approximately $8.3 million in operating lease commitments on facility leases that were assigned to Mindspeed and Skyworks at the time of their separation from the Company.

In connection with acquisitions in fiscal 2004 and 2005, the Company is contingently liable for an aggregate of up to $6.0 million of milestone and earn-out payments through January 2006. In addition, see Note 2 regarding the contingent amounts for the stock price guarantee in the Amphion acquisition.

In connection with certain non-marketable equity investments, the Company may be required to invest up to an additional $5.9 million as of June 30, 2005.

The Company has made commitments to certain employees in the amount of $1.3 million as of June 30, 2005. Such amounts will be earned and paid over the next six months.

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6. Comprehensive Loss

Comprehensive loss is as follows (in thousands):

	Three months ended June 30,		Nine months ended June 30,	
	2005	**2004**	**2005**	**2004**
Net loss	$(32,166)	$(71,426)	$(226,071)	$(174,158)
Other comprehensive income (loss):				
Foreign currency translation adjustments	(481)	(556)	398	346
Change in unrealized gains on available-for-sale securities	29,387	65,762	(13,964)	67,441
Reclassification adjustment for realized gains on available-for-sale securities included in net loss	(26,987)		(38,247)	
Minimum pension liability adjustments	69	87	207	260
Effect of income taxes				172
Other comprehensive income (loss)	1,988	65,293	(51,606)	68,219
Comprehensive loss	$(30,178)	$ (6,133)	$(277,677)	$(105,939)

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

	June 30, 2005	September 30, 2004
Foreign currency translation adjustments	$ (2,808)	$ (3,206)
Unrealized gains on available-for-sale securities	40,247	92,458
Minimum pension liability adjustments	(6,494)	(6,701)
Accumulated other comprehensive income	$30,945	$ 82,551

7. Special Charges

Special charges consist of the following (in thousands):

	Three months ended June 30,		Nine months ended June 30,	
	2005	**2004**	**2005**	**2004**
Asset impairments	$ 29	$2,508	$ 3,492	$ 4,534
Restructuring charges	6,731	3,627	24,470	4,075
Integration charges	1,649	1,565	6,760	4,168
Other		594	6,540	1,636

	$8,409	$8,294	$41,262	$14,413

Asset Impairments

During the nine months ended June 30, 2005, the Company recorded asset impairment charges of $3.5 million related primarily to leasehold improvements on operating properties that have been or will be vacated as part of the Company s restructuring actions.

During the nine months ended June 30, 2004 in connection with the Merger, the Company recorded asset impairment charges of $4.5 million related to various Conexant operating assets which were determined to be redundant and no longer required as a result of the Merger. These assets have been abandoned.

Restructuring Charges

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

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

2005 Restructuring Action In November 2004, the Company announced additional plans to reduce its operating expense level by the end of the fourth fiscal quarter of 2005. The components of this plan are a shift of product development resources to lower-cost regions and cost savings from continued Merger-related sales, general and administrative consolidation. During the nine months ended June 30, 2005, the Company announced several other site closures and further workforce reductions. In total, the Company notified approximately 255 employees of their involuntary termination, including approximately 175 domestic and 80 international employees. Certain employees were offered relocation opportunities. As of June 30, 2005, some of these employees have left the Company, and others will be transitioning their work over the next three months. The workforce reductions affected employees in all areas of the business. During the nine months ended June 30, 2005, the Company recorded total charges of $17.8 million based on the estimates of the cost of severance benefits for the affected employees, and the estimated relocation benefits for those employees who have been offered and have commenced the relocation process. The Company will charge an additional $1.3 million to restructuring expense in the fourth fiscal quarter as certain severance benefits are earned. Additionally, the Company has recorded restructuring charges of $4.9 million in the first nine months of 2005 relating to the consolidation of certain facilities under non-cancelable leases which were vacated. The facility charges were determined in accordance with the provisions of SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities . As a result, the Company recorded the present value of the future lease obligations, in excess of the expected future sublease income, using a discount rate of 8.0%, and will accrete the remaining approximate $2.0 million into expense over the remaining life of the leases. The accrual for facility charges includes a $1.0 million non-cash reclassification of a portion of the deferred gain on the previous sale-leaseback of the facility, which has now been partially vacated.

Activity and liability balances recorded as part of the 2005 Restructuring Action through June 30, 2005 were as follows (in thousands):

	Workforce reductions	Facility and other	Total
Charged to costs and expenses	$ 6,073	$4,006	$10,079
Non-cash items	(22)	979	957
Cash payments	(3,333)		(3,333)
Restructuring balance, December 31, 2004	2,718	4,985	7,703
Charged to costs and expenses	5,936	74	6,010
Cash payments	(2,819)	(168)	(2,987)
Restructuring balance, March 31, 2005	5,835	4,891	10,726
Charged to costs and expenses	5,837	864	6,701
Non-cash items	(23)		(23)
Cash payments	(3,937)	(203)	(4,140)
Restructuring balance, June 30, 2005	$ 7,712	$5,552	$13,264

2004 Restructuring Actions The Company approved several restructuring plans during fiscal 2004. In connection with the Merger, the Company began to formulate plans which included workforce reductions and facility consolidation actions. These plans were communicated at the time of the Merger and have been completed (the 2004 Merger

Related Restructuring and Reorganization Plans). During the fourth fiscal quarter of 2004, the Company announced additional workforce reduction and facility consolidation actions in response to lower than anticipated revenue levels. In connection with the Merger, the Company began to formulate the 2004 Merger Related Reorganization Plan which consisted primarily of workforce reductions to eliminate redundant positions and consolidation of worldwide facilities. The portions of the plan that pertained to Conexant, Inc. employees and facilities were recorded as acquired liabilities in the Merger and included as part of the purchase price allocation, in accordance with EITF No. 95-3 and SFAS No. 141. This plan consisted of an involuntary workforce reduction which affected approximately 35 employees of Conexant, Inc. These employees were located in the United States in sales and administrative functions. The charge associated with these workforce reductions of approximately $1.3 million was based upon estimates of the severance and fringe benefits for the affected employees, in addition to relocation benefits for

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others. The facility consolidation plan resulted in an initial charge of $13.5 million and included assumptions regarding sublease rates and time periods and other costs to prepare and sublease the applicable spaces. Additionally, at the date of the Merger, there had been a decline in the real estate market in certain geographic regions in which Conexant, Inc. had leased facilities. A portion of the facilities related charges represent adjustments to the fair market value rates of those leases. These non-cancelable lease commitments range from near term to 17 years in length. In fiscal 2004, the Company reduced the original facility consolidation charge by approximately $3.6 million and increased the workforce related charge by approximately $0.2 million as a result of finalizing the 2004 Merger Related Reorganization Plan and recorded these changes as adjustments to the purchase price allocation (goodwill). In the quarter ended March 31, 2005, as a result of finalizing facilities consolidation actions, the Company reduced its facilities reserves by a total of $1.2 million as adjustments to the purchase price allocation (goodwill).

Activity and liability balances recorded as part of the 2004 Merger Related Reorganization Plan pertaining to Conexant, Inc. employees and facilities through June 30, 2005 were as follows (in thousands):

	Workforce reductions	Facility and other	Total
Recorded in purchase price allocation	$1,300	$13,509	$14,809
Adjusted to purchase price allocation	210	(3,554)	(3,344)
Cash payments	(536)	(788)	(1,324)
Restructuring balance, September 30, 2004	974	9,167	10,141
Cash payments	(277)	(273)	(550)
Restructuring balance, December 31, 2004	697	8,894	9,591
Adjusted to purchase price allocation		(1,226)	(1,226)
Cash payments	(444)	(241)	(685)