

GENESIS MICROCHIP INC /DE  
Form 10-Q  
February 08, 2006  
Table of Contents

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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, DC 20549

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**FORM 10-Q**

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(mark one)

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

**FOR THE QUARTERLY PERIOD ENDED December 31, 2005**

**OR**

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

**FOR THE TRANSITION PERIOD FROM \_\_\_\_\_ TO \_\_\_\_\_**

**COMMISSION FILE NUMBER:**

**000-33477**

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**GENESIS MICROCHIP INC.**

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(Exact name of registrant as specified in its charter)

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**DELAWARE**  
(State or other jurisdiction of  
incorporation or organization)

**77-0584301**  
(I.R.S. Employer  
Identification No.)

**2150 GOLD STREET**

**P.O. BOX 2150**

**ALVISO, CALIFORNIA**  
(Address of principal executive offices)

**95002**  
(Zip Code)

**REGISTRANT'S TELEPHONE NUMBER, INCLUDING AREA CODE: (408) 262-6599**

**Former name, former address and former fiscal year if changed since last report.**

**Former address: N/A**

**Former Fiscal Year: N/A**

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

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

Large accelerated filer  Accelerated filer  Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act): Yes  No

There were 35,478,148 shares of the registrant's common shares issued and outstanding as of December 31, 2005.



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**Table of Contents**

**GENESIS MICROCHIP INC.**

**FORM 10-Q**

**THREE MONTHS ENDED DECEMBER 31, 2005**

**Index**

<b><u>Item Number</u></b>	<b><u>Page</u></b>
<b>Part I: Financial Information</b>	
Item 1. <u>Financial Statements</u>	
<u>Condensed Consolidated Balance Sheets at December 31, 2005 and March 31, 2005</u>	1
<u>Condensed Consolidated Statements of Operations for the three and nine months ended December 31, 2005 and December 31, 2004</u>	2
<u>Condensed Consolidated Statements of Cash Flows for the nine months ended December 31, 2005 and December 31, 2004</u>	3
<u>Notes To Condensed Consolidated Financial Statements</u>	4
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	10
Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	28
Item 4. <u>Controls and Procedures</u>	29
<b>Part II: Other Information</b>	
Item 1. <u>Legal Proceedings</u>	29
Item 2. Unregistered Sales of Equity Securities and Use of Proceeds	*
Item 3. Defaults Upon Senior Securities	*
Item 4. Submission of Matters to a Vote of Security Holders	*
Item 5. Other Information	*
Item 6. <u>Exhibits</u>	30
<b><u>Signatures</u></b>	

\* No information has been provided because this item is not applicable.

**Table of Contents****PART I: FINANCIAL INFORMATION****ITEM 1: FINANCIAL STATEMENTS****GENESIS MICROCHIP INC.****CONDENSED CONSOLIDATED BALANCE SHEETS**

(amounts in thousands, except per share amounts)

	December 31, 2005	March 31, 2005
	(unaudited)	(unaudited)
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 113,215	\$ 129,757
Short-term investments	62,000	
Accounts receivable trade, net of allowance for doubtful accounts of \$390 at December 31 and \$204 at March 31	37,245	30,310
Inventories	23,187	17,557
Prepays and other	6,849	5,583
<b>Total current assets</b>	<b>242,496</b>	<b>183,207</b>
Property and equipment	17,873	15,987
Intangible assets	9,651	17,265
Goodwill	181,981	181,981
Deferred income taxes	10,238	14,056
Other	5,131	3,796
<b>Total assets</b>	<b>\$ 467,370</b>	<b>\$ 416,292</b>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 10,264	\$ 12,044
Accrued liabilities	20,432	11,634
Income taxes payable	2,558	3,118
<b>Total current liabilities</b>	<b>33,254</b>	<b>26,796</b>
Stockholders' equity:		
Capital stock:		
Preferred stock:		
Authorized - 5,000 preferred shares, \$0.001 par value		
Issued and outstanding - none at December 31 and at March 31		
Common stock:		
Authorized - 100,000 common shares, \$0.001 par value		
Issued and outstanding - 35,478 shares at December 31 and 33,479 shares at March 31	35	33
Additional paid-in capital	434,703	405,323

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Cumulative other comprehensive loss	(94)	(94)
Deferred stock-based compensation	(3,701)	(232)
Retained earnings (deficit)	3,173	(15,534)
	<u>          </u>	<u>          </u>
Total stockholders' equity	434,116	389,496
	<u>          </u>	<u>          </u>
Total liabilities and stockholders' equity	\$ 467,370	\$ 416,292
	<u>          </u>	<u>          </u>

See accompanying notes to condensed consolidated financial statements.

**Table of Contents****GENESIS MICROCHIP INC.****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

(amounts in thousands, except per share amounts)

(unaudited)

	Three Months Ended December 31		Nine Months Ended December 31	
	2005	2004	2005	2004
Revenues	\$ 73,965	\$ 48,286	\$ 208,644	\$ 151,210
Cost of revenues (1)	37,810	26,609	111,553	87,116
Gross profit	36,155	21,677	97,091	64,094
Operating expenses:				
Research and development (2)	11,839	9,324	32,885	28,672
Selling, general and administrative (3)	12,195	14,218	35,040	34,932
Amortization of acquired intangibles	2,654	2,654	7,962	7,962
Total operating expenses	26,688	26,196	75,887	71,566
Income (loss) from operations	9,467	(4,519)	21,204	(7,472)
Interest income	1,519	534	3,496	1,253
Income (loss) before income taxes	10,986	(3,985)	24,700	(6,219)
Provision for (recovery of) income taxes	3,621	(2,985)	5,993	(3,616)
Net income (loss)	\$ 7,365	\$ (1,000)	\$ 18,707	\$ (2,603)
Earnings (loss) per share:				
Basic	\$ 0.21	\$ (0.03)	\$ 0.54	\$ (0.08)
Diluted	\$ 0.20	\$ (0.03)	\$ 0.51	\$ (0.08)
Weighted average number of common shares outstanding:				
Basic	35,413	33,151	34,632	32,969
Diluted	37,295	33,151	36,718	32,969
(1) Amount excludes amortization of acquired developed technology included in amortization of acquired intangibles	\$ 1,925	\$ 1,925	\$ 5,775	\$ 5,775
(2) Amount includes stock-based compensation expense	\$ 101	\$ 408	\$ 280	\$ 1,605
(3) Amount includes stock-based compensation expense	\$ 260	\$ 2,057	\$ 372	\$ 2,457

See accompanying notes to condensed consolidated financial statements.

**Table of Contents****GENESIS MICROCHIP INC.****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

(amounts in thousands)

(unaudited)

	Nine Months Ended	
	December 31	
	2005	2004
Cash flows from (used in) operating activities:		
Net income (loss)	\$ 18,707	\$ (2,603)
Adjustments to reconcile net income (loss) to net cash from operating activities:		
Depreciation and amortization	5,559	5,281
Amortization of intangible assets	7,962	7,962
Stock-based compensation	652	4,062
Deferred income taxes	3,818	(4,168)
Other	453	104
Change in operating assets and liabilities, net of amounts acquired:		
Accounts receivable trade	(6,935)	1,897
Inventories	(5,630)	2,065
Prepays and other	(1,535)	570
Accounts payable	(1,780)	(2,201)
Accrued liabilities	8,798	2,225
Income taxes payable	(560)	627
Net cash from operating activities	29,509	15,821
Cash flows used in investing activities:		
Purchase of short-term investments	(71,733)	(174,683)
Proceeds on maturity of short-term investments	10,002	181,707
Additions to property and equipment	(6,705)	(4,396)
Other	(2,876)	(3,518)
Net cash used in investing activities	(71,312)	(890)
Cash flows from financing activities:		
Proceeds from issue of common stock	25,261	5,190
Net cash provided by financing activities	25,261	5,190
Increase (decrease) in cash and cash equivalents	(16,542)	20,121
Cash and cash equivalents, beginning of period	129,757	19,241
Cash and cash equivalents, end of period	\$ 113,215	\$ 39,362

See accompanying notes to condensed consolidated financial statements.





**Table of Contents**

**GENESIS MICROCHIP INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(unaudited)**

**1. Basis of presentation**

We have prepared the accompanying unaudited condensed consolidated financial statements in accordance with generally accepted accounting principles in the United States ( GAAP ) and according to the rules and regulations of the Securities and Exchange Commission for interim financial reporting. Consequently, they do not include all of the information and footnotes required by GAAP for a complete set of annual financial statements. These condensed financial statements should be read in conjunction with our financial statements and notes thereto for the year ended March 31, 2005 that are included in our most recent Annual Report on Form 10-K/A filed with the Securities and Exchange Commission. We believe that the accompanying financial statements reflect all adjustments, consisting solely of normal, recurring adjustments, that are necessary for a fair presentation of the results for the interim periods presented. The results of operations for the period ended December 31, 2005 are not necessarily indicative of the results to be expected for the full fiscal year or for any other period.

Beginning with the three month period ended June 30, 2005, we changed the method in which certain costs are allocated to research and development expenses and selling, general and administrative expenses. We believe that the current allocation method more appropriately reflects the nature of these expenses and the services to which they relate. The condensed consolidated statement of operations for the three months and nine months ended December 31, 2004 have been reclassified in order to present comparable statements for the two periods. The restatement has no effect on total operating expenses, net loss, or net loss per share.

**2. Stock-based compensation**

We have elected to follow Accounting Principles Board Opinion No. 25 ( APB 25 ), Accounting for Stock Issued to Employees and related interpretations, in accounting for employee stock options and restricted stock units. Under APB 25, deferred stock-based compensation is recorded at the grant date in an amount equal to the excess of the market value of a share of common stock over the exercise price of the option or restricted stock unit. Since restricted stock units have no exercise price, the deferred stock-based compensation is reflective of the market value of the stock on the date of grant. Deferred stock-based compensation is amortized over the vesting period of the individual options or stock units, generally two to four years, in accordance with Financial Accounting Standards Board's ( FASB ) FIN 44.

In the quarter ended September 30, 2005, the Company amended the 1997 Employee Stock Option Plan to allow the granting of stock appreciation rights, stock purchase rights, and restricted stock units, and amended the 2000 Nonstatutory Stock Option Plan to allow the granting of stock appreciation rights.

Stock-based compensation expense resulting from the issuance of options to non-employees is recognized as services are performed and the options are earned. Genesis applies the fair value method of FASB's SFAS 123, Accounting for Stock-based Compensation, for valuing options granted to non-employees.

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SFAS 123 requires disclosure of pro forma net income and earnings per share had Genesis adopted the fair value method for all stock option grants as of the beginning of its 1997 fiscal year. Under SFAS 123, the fair value of stock-based awards to employees is calculated through the use of option pricing models, even though such models were developed to estimate the fair value of freely tradable, fully transferable options without vesting restrictions, which significantly differ from Genesis's stock option awards. These models also require subjective assumptions, including future stock price volatility and expected time to exercise, which greatly affect the calculated values. Genesis's calculations were made using the Black-Scholes option-pricing model using a dividend yield of 0% and the assumptions noted in the following tables:

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>December 31</b>		<b>December 31</b>	
	<b>2005</b>	<b>2004</b>	<b>2005</b>	<b>2004</b>
<b>Stock Option Plans:</b>				
Risk-free interest rates	4.3%	3.6%	4.3%	3.6%
Volatility	80%	102%	80%	102%
Expected life in years	4.25	5	4.25	5
<b>Employee Stock Purchase Plans:</b>				
Risk-free interest rates	4.4%	2.6%	4.4%	2.6%
Volatility	80%	102%	80%	102%
Expected life in years	1.25	1.25	1.25	1.25

**Table of Contents**

The weighted average fair values of options granted during the three months ended December 31, 2005 and December 31, 2004 were \$ 12.60 and \$ 11.66 respectively.

The weighted average fair values of options granted during the nine months ended December 31, 2005 and December 31, 2004 were \$ 12.67 and \$ 10.71 respectively.

During the three months ended December 31, 2005, restricted stock units ( RSUs ) were issued to employees as part of a new stock-based incentive program. The \$4.1 million intrinsic value of these units is being amortized over the vesting period of the awards, which is four years. The expense is categorized in the statement of operations in accordance with the nature of the service provided by the related employees. The expense for the three months ended December 31, 2005, was \$0.4 million.

Had compensation expense been determined based on the fair value of awards at the grant dates in accordance with the methodology prescribed in SFAS 123, Genesis' s net income (loss) and earnings (loss) per share for the three months and nine months ended December 31, 2005 and 2004 would approximate the pro forma disclosure as follows (in thousands, except per share amounts):

	Three Months Ended		Nine Months Ended	
	December 31		December 31	
	2005	2004	2005	2004
<b>Net income (loss) attributable to common stockholders:</b>				
As reported	\$ 7,365	\$ (1,000)	\$ 18,707	\$ (2,603)
Stock compensation, as reported	361	2,465	652	4,062
Stock compensation, under SFAS 123	(5,841)	(8,557)	(17,110)	(19,979)
<b>Pro forma</b>	<b>\$ 1,885</b>	<b>\$ (7,092)</b>	<b>\$ 2,249</b>	<b>\$ (18,520)</b>
<b>Basic earnings (loss) per share:</b>				
As reported	\$ 0.21	\$ (0.03)	\$ 0.54	\$ (0.08)
<b>Pro forma</b>	<b>\$ 0.05</b>	<b>\$ (0.21)</b>	<b>\$ 0.06</b>	<b>\$ (0.56)</b>
<b>Diluted earnings (loss) per share:</b>				
As reported	\$ 0.20	\$ (0.03)	\$ 0.51	\$ (0.08)
<b>Pro forma</b>	<b>\$ 0.05</b>	<b>\$ (0.21)</b>	<b>\$ 0.06</b>	<b>\$ (0.56)</b>

**3. Earnings (loss) per share**

Basic earnings (loss) per share is computed by dividing the net income (loss) in a period by the weighted average number of shares of common stock outstanding during that period. Diluted earnings (loss) per share is calculated in order to give effect

**Table of Contents**

to all potential dilutive shares of common stock issuable during the period on the exercise of outstanding options or warrants. The weighted average number of diluted shares outstanding is calculated by assuming that any proceeds from the issuance of potential shares of common stock, such as stock options, are used to repurchase shares of common stock at the average market share price in the period. Per share information calculated on this basis is as follows (in thousands, except for share amounts):

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>December 31</b>		<b>December 31</b>	
	<b>2005</b>	<b>2004</b>	<b>2005</b>	<b>2004</b>
<b>Numerator for basic and diluted earnings (loss) per share:</b>				
Net income (loss)	\$ 7,365	\$ (1,000)	\$ 18,707	\$ (2,603)
<b>Denominator for basic earnings (loss) per share:</b>				
Weighted average common shares	35,413	33,151	34,632	32,969
<b>Basic earnings (loss) per share:</b>	<b>\$ 0.21</b>	<b>\$ (0.03)</b>	<b>\$ 0.54</b>	<b>\$ (0.08)</b>
<b>Denominator for diluted earnings (loss) per share:</b>				
Weighted average common shares	35,413	33,151	34,632	32,969
Stock options and warrants	1,882		2,086	
<b>Shares used in computing diluted earnings (loss) per share</b>	<b>37,295</b>	<b>33,151</b>	<b>36,718</b>	<b>32,969</b>
<b>Diluted earnings (loss) per share:</b>	<b>\$ 0.20</b>	<b>\$ (0.03)</b>	<b>\$ 0.51</b>	<b>\$ (0.08)</b>
<b>Anti-dilutive potential common shares excluded from above calculation</b>	<b>5,528</b>	<b>8,573</b>	<b>5,851</b>	<b>8,073</b>

Had we been profitable during the three and nine months ended December 31, 2004, the weighted average number of shares outstanding for purposes of calculating diluted earnings per share would have been increased by 1,430,000 and 1,232,000 respectively.

**4. Segmented information****Market information**

Genesis operates and tracks its results in one operating segment. Genesis designs, develops and markets integrated circuits that manipulate and process digital video and graphic images. The target market is the advanced display market including LCD monitors and flat-panel televisions.

**Geographic information**

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Geographic revenue information is based on the shipment destination. Long-lived assets include property and equipment, as well as intangible assets and goodwill. Property and equipment information is based on the physical location of the asset while the intangible assets are based on the location of the owning entity. Revenues from unaffiliated customers by geographic region were as follows (in thousands):

	<b>Three Months Ended December 31</b>		<b>Nine Months Ended December 31</b>	
	<b>2005</b>	<b>2004</b>	<b>2005</b>	<b>2004</b>
United States	\$ 393	\$ 2,474	\$ 3,103	\$ 6,588
China	31,964	17,870	91,183	61,027
Europe	10,104	2,716	23,232	9,281
Japan	7,537	3,744	22,016	10,909
South Korea	13,722	12,756	39,274	36,725
Taiwan	8,059	7,141	21,158	22,390
Rest of world	2,186	1,585	8,678	4,290
	<b>\$ 73,965</b>	<b>\$ 48,286</b>	<b>\$ 208,644</b>	<b>\$ 151,210</b>

**Table of Contents**

Net long-lived assets by country were as follows (in thousands):

	<b>December 31, 2005</b>	<b>March 31, 2005</b>
United States	\$ 200,108	\$ 206,728
Rest of world	9,397	8,505
	<b>\$ 209,505</b>	<b>\$ 215,233</b>

**Customer concentration information**

The following table shows the percentage of our revenues in each period that was derived from customers who individually accounted for more than 10% of revenues in that period:

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>December 31</b>		<b>December 31</b>	
	<b>2005</b>	<b>2004</b>	<b>2005</b>	<b>2004</b>
Customer A	15%	16%	15%	12%
Customer B	10%		10%	10%
Customer C			10%	

The following table shows customers accounting for more than 10% of accounts receivable trade at December 31, 2005 and March 31, 2005:

	<b>December 31, 2005</b>	<b>March 31, 2005</b>
Customer 1	25%	29%
Customer 2	13%	
Customer 3	11%	

**Supplier arrangements**

Genesis subcontracts portions of its semiconductor manufacturing from several suppliers and, for the vast majority of products, no single production process for any single product is performed by more than one supplier. Should our wafer supplier or any of Genesis's packaging or testing subcontractors cease to be available, management believes that this would have a material adverse effect on Genesis's business, financial condition and results of operations. Genesis has no guarantee of minimum capacity from its suppliers, long term pricing agreements, and is not liable for any significant minimum purchase commitments.

**5. Inventories**

Inventories consist of the following (in thousands):

	<b>December 31, 2005</b>	<b>March 31, 2005</b>
Finished goods	\$ 9,310	\$ 11,156
Work-in-process	16,861	9,355
	<u>26,171</u>	<u>20,511</u>
Less: Inventory reserve	(2,984)	(2,954)
	<u>\$ 23,187</u>	<u>\$ 17,557</u>

The following table presents a roll forward of the inventory obsolescence reserve for the indicated periods (in thousands):

	<b>Three Months Ended December 31</b>		<b>Nine Months Ended December 31</b>	
	<b>2005</b>	<b>2004</b>	<b>2005</b>	<b>2004</b>
Balance at beginning of period	\$ 2,331	\$ 3,758	\$ 2,954	\$ 3,243
Increase (decrease) to cost of revenues	653	(296)	316	511
Charge offs		(418)	(286)	(710)
Balance at end of period	<u>\$ 2,984</u>	<u>\$ 3,044</u>	<u>\$ 2,984</u>	<u>\$ 3,044</u>



**Table of Contents****6. Product warranty**

Genesis accrues the estimated future cost of replacing faulty product under the provisions of its warranty agreements as an increase to cost of revenues. Product warranties typically cover a one-year period from the date of delivery to the customer. Management estimates the accrual based on known product failures (if any), historical experience, and other currently available evidence. The following table presents a roll forward of the product warranty reserve for the indicated periods (in thousands):

	Three Months Ended		Nine Months Ended	
	December 31		December 31	
	2005	2004	2005	2004
Balance at beginning of period	\$ 173	\$ 200	\$ 230	\$ 200
Increase to provision	2	18	5	135
Charge offs	(2)	(11)	(62)	(128)
Balance at end of period	\$ 173	\$ 207	\$ 173	\$ 207

**7. Intangible assets**

Intangible assets consist of the following:

	December 31, 2005			March 31, 2005		
	Cost	Accumulated		Cost	Accumulated	
		Amortization	Net		Amortization	Net
Acquired technology	\$ 47,100	\$ 40,353	\$ 6,747	\$ 47,100	\$ 32,489	\$ 14,611
Patents	3,800	902	2,898	3,235	685	2,550
Other	500	494	6	500	396	104
Total	\$ 51,400	\$ 41,749	\$ 9,651	\$ 50,835	\$ 33,570	\$ 17,265

Estimated future intangible assets amortization expense, based on current balances as of December 31, 2005, is as follows:

For the year ended:	December 31
2006	\$ 3,208
2007	1,966

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2008	1,942
2009	602
2010	186
Thereafter	1,747
Total	<u>\$ 9,651</u>

**8. Contingent liabilities**

Silicon Image Litigation

In April 2001, Silicon Image, Inc. ( Silicon Image ) filed a patent infringement

## Table of Contents

lawsuit against Genesis in the United States District Court for the Eastern District of Virginia ( District Court ) and simultaneously filed a complaint before the United States International Trade Commission ( ITC ). The complaint and suit alleged that certain Genesis products that contain digital receivers infringe various Silicon Image patent claims. Silicon Image was seeking an injunction to halt the sale, manufacture and use of Genesis' s DVI receiver products and unspecified monetary damages. In December 2001, Silicon Image formally moved to withdraw its complaint before the ITC and those proceedings have terminated.

In July 2003, the District Court issued a memorandum opinion, followed by a final judgment in August 2003 and an amended final judgment in December 2003. In its opinion, the District Court ruled that Genesis and Silicon Image have settled their disputes based on a Memorandum of Understanding, or MOU, signed on December 18, 2002. The District Court' s opinion states that the MOU is a binding settlement agreement and that Genesis will pay Silicon Image a monetary settlement, license fee and running royalties on all DVI and HDMI products. We have been reserving the estimated amounts payable to Silicon Image pursuant to the District Court' s judgment regarding the MOU, beginning in the year ended March 31, 2003. A portion of this estimated reserve was paid into an escrow pursuant to a court order. These amounts have been accounted for as reductions of the related liability. In July 2005, the District Court dismissed the case with prejudice. In August 2005, Genesis filed a notice of appeal to the Federal Circuit Court of Appeals. The District Court stayed its judgment pending the resolution of Genesis' s appeal.

The future financial impact arising from any appeal or other legal actions related to the dispute is not yet determinable and no other provision has been made in our consolidated financial statements for any future costs associated with this claim.

## Mstar Litigation

Genesis filed a patent infringement complaint against MStar Semiconductor, Inc. ( Mstar ) and other respondents in the U.S. International Trade Commission ( ITC ). In August 2004, the ITC determined that MStar and the other respondents infringe Genesis' s patent, and issued an exclusion order preventing the importation of MStar' s and the other respondents' infringing display controllers into the United States, as well as LCD monitors and boards containing these products. However, U.S. Customs has declined to enforce the ITC' s exclusion order against MStar' s Tsunami (or TSU) products. In December 2004, Mstar filed an appeal of the exclusion order and related ITC rulings to the Federal Circuit Court of Appeals. The other respondents did not appeal.

The future financial impact of this dispute is not determinable and no provision has been made in our consolidated financial statements for any future costs or settlements associated with these claims.

## **9. Recent Accounting Pronouncements**

In December 2004, the FASB issued SFAS 123 (revised 2004), Share-Based Payment ( SFAS 123R ). SFAS 123R is a revision to SFAS 123 and supersedes APB 25, and its related implementation guidance. In March 2005, the Securities and Exchange Commission ( SEC ) issued Staff Accounting Bulletin No. 107 ( SAB 107 ) to provide guidance for public companies concerning SFAS 123R and various SEC rules and regulations. SFAS 123R establishes standards for the accounting for transactions in which an entity exchanges its equity instruments for goods or services. It also addresses transactions in which an entity incurs liabilities in exchange for goods or services that are based on the fair value of the entity' s equity instruments or that may be settled by the issuance of those equity instruments. SFAS 123R focuses primarily on accounting for transactions in which an entity obtains employee services in share-based payment transactions.

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SFAS 123R does not change the accounting guidance for share-based payment transactions with parties other than employees provided in SFAS 123 as originally issued and EITF Issue No. 96-18, Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services. SFAS 123R does not address the accounting for employee share ownership plans, which are subject to AICPA Statement of Position 93-6, Employers Accounting for Employee Stock Ownership Plans .

## **Table of Contents**

Pursuant to SFAS 123R, a public entity will initially measure the cost of employee services received in exchange for an award of liability instruments based on its current fair value; the fair value of that award will be re-measured subsequently at each reporting date through the settlement date. Changes in fair value during the requisite service period will be recognized as compensation cost over that period.

The grant-date fair value of employee share options and similar instruments will be estimated using the option-pricing models adjusted for the unique characteristics of those instruments (unless observable market prices for the same or similar instruments are available).

Excess tax benefits, as defined by SFAS 123R, will be recognized as an addition to paid-in-capital. Cash retained as a result of those excess tax benefits will be presented in the statement of cash flows as financing cash inflows. Currently, they are classified as operating cash flows. The write-off of deferred tax assets relating to unrealized tax benefits associated with recognized compensation cost will be recognized as income tax expense unless there are excess tax benefits from previous awards remaining in paid-in capital to which it can be offset.

We have not made a final determination on the valuation model, methodology, or other impacts of implementing SFAS 123R on our financial statements. For an illustration of the effect of using a fair-value based method of accounting for share-based payment transactions on our recent results of operations, see Note 2. The effective date to the Company will be as of April 1, 2006.

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

*The following contains 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, including statements regarding anticipated revenues, gross margins, operating expenses, amortization of intangibles and stock-based compensation, liquidity and cash flow, business strategy, demand for our products, average selling prices, regional market growth, and future competition. Words such as anticipates, expects, intends, plans, believes, seeks, estimates and similar expressions identify such forward-looking statements. These forward-looking statements are subject to risks and uncertainties that could cause actual results to differ materially from those indicated in the forward-looking statements. Factors which could cause actual results to differ materially include those set forth in the following discussion, and, in particular, the risks discussed below under the subheading Risk Factors and in other documents we file with the Securities and Exchange Commission. Unless required by law, we undertake no obligation to update publicly any forward-looking statements.*

We begin Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A) with a general discussion of our target markets, the nature of our products, and some of the business issues we are facing as a company. Next, we address the Critical Accounting Policies and Estimates that we believe are important to understanding the assumptions and judgments incorporated in our reported financial results. We then discuss our Results of Operations for the three and nine month periods ended December 31, 2005 and the three and nine month periods December 31, 2004, and corresponding quarterly information within those quarters as viewed through the eyes of Management. Lastly, we provide an analysis of changes in our balance sheet and cash flows, and discuss our financial commitments. This MD&A should be read in conjunction with the other sections of this Quarterly Report on Form 10-Q.

## **Table of Contents**

### **OVERVIEW**

#### **Our Markets**

We develop and market image and video processing solutions. We design, develop and market integrated circuits that receive and process digital video and graphic images. We also supply reference boards and designs that incorporate our software and proprietary integrated circuits, or chips. Our products are primarily used in liquid crystal displays ( LCDs ). These displays may be used in desktop monitor applications. Our products are also used in other types of display devices, including LCD TVs, Plasma TVs, Rear Projection TVs, and Digital CRT TVs.

We generate the majority of our revenue by selling our image-processing solutions to the manufacturers of LCD monitors and television sets. We outsource the manufacturing of our products to large semiconductor manufacturers, thereby eliminating the need for capital-intensive plant and equipment. Our targeted long-term gross profit percentage is in the 42% to 45% range. Our most significant cash operating expense is labor, with our workforce employed in research and development of new products and technologies and in marketing, sales, customer support, and distribution of our products.

Our end target markets are LCD computer monitors and flat panel televisions. We also design products that serve both applications, the so-called multi-function monitors ( MFMs ). MFMs represent a category in which it is difficult to distinguish between a monitor with television capability and a television with a PC input. Both of these display devices could use the same Genesis chip. Similarly, we supply certain customers with chips originally designed for a LCD computer monitor that the customer may use in flat panel televisions. We assist customers in developing their designs. At times, customers will use a two-chip solution in their TV designs. As semiconductor manufacturers continue to integrate more TV functionality into their chips, customers will typically transition over time to single-chip solutions which may impact overall revenue and unit growth potential. In general, a TV design will take more time and support from our software and field application engineers than a monitor design, increasing our costs during a customer's pre-production period.

The growth in our target markets is limited by the industry's capacity to supply LCD panels or other digital displays. Furthermore, the availability of LCD panels from time to time has been constrained, causing unexpected increases in the cost of LCD panels to our customers, thus resulting in customers rapidly changing their demand expectations for our products. Our products usually represent less than two percent of the average retail cost of a standard flat panel TV today, while the cost of the LCD panel within a LCD computer monitor or flat panel TV represents the majority of the cost of the finished product. Consequently, constraints on availability of LCD panels or increases in panel costs can result in reduced demand for our products, and it is very difficult to accurately predict the availability or cost of LCD panels and well beyond our means to control. Conversely, it is the increase in production volumes of larger size LCD panels in new fabrication facilities coming on line over the next several years that is expected to result in lower-cost panels and hence lower average selling prices of the end product. We believe retail prices for flat-panel televisions will continue to decline in the coming quarters and we expect this to lead to an increase in demand for flat-panel television display controllers.

Our industry is very competitive and growth industries like ours tend to attract new entrants. The LCD computer monitor industry is highly competitive. Our average selling prices of monitor display controllers, in spite of increased functionality have declined by more than 50% over the past two fiscal years. We expect the flat panel television industry will be as competitive over time. Our strategy is to maintain market leadership through integration of new features and functions and by providing the highest image quality at a cost-effective price. We believe we are able to deliver the desired feature-rich image quality through relationships with customers, patented technologies, effective chip design, software capabilities, and customer support. While maintaining our leadership in image quality and product feature sets, we strive to maximize profitability by reducing product cost through efficient chip design and driving costs down throughout our supply chain.

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While we primarily market and sell our integrated circuits directly to manufacturers, we have sold finished systems, primarily to the high-end home theater market, under the Faroudja brand. These products were generally sold through specialty retail channels and represented a very small portion of our overall revenue (less than 2.5% of revenue for the fiscal year ended March 31, 2005). During the quarter ended June 30, 2005, we entered into a strategic alliance with Meridian Audio Limited that gives Meridian the right to manufacture and distribute Genesis's Faroudja home theater solutions, and to promote the Faroudja brand, on a worldwide

## **Table of Contents**

basis as part of Meridian's product portfolio. These products will be marketed and distributed through Meridian's global distribution network. While Genesis will continue to develop advanced Faroudja algorithms for integration into its integrated circuit ( IC ) products, it has discontinued the manufacture and sale of its home theater systems.

Sales to distributors comprised 23% of revenues for the quarter ended December 31, 2005. We are also using distributor relationships to enable us to increase our market penetration of smaller customers with minimal incremental direct customer support.

Average selling prices and product margins of our products are typically highest during the initial periods following product introduction and decline over time and as volume increases.

Part of our overall strategy is to develop intellectual property that is used in our integrated circuits. We have and will continue to defend our intellectual property rights against those companies that may use our technology without the proper authorization. At times we may enter into agreements that allow customers or other companies to license our patented technology.

## **Revenue Recognition**

Genesis recognizes revenue from semiconductor product sales to customers when a contract is established, the price is determined, shipment is made and collectability is reasonably assured. Product sales to distributors may be subject to a right of return on termination of the distributor relationship. Revenue, and related cost of revenues from sales to distributors, is deferred until the distributors resell the product, verified by point-of-sale reports. At the time of shipment to distributors, we record a trade receivable for the selling price, relieve inventory of the value of the product shipped and record the gross margin as a component of accrued liabilities on our consolidated balance sheet. In certain circumstances, where orders are placed with non-cancelable/non-return terms we recognize revenue upon shipment. Reserves for sales returns and allowances are recorded at the time of recognizing revenue. To date we have not experienced significant product returns.

## **Manufacturing and Supply**

We generally need to place purchase orders for products before we receive purchase orders from our customers. This is because production lead times for silicon wafers and substrates, from which our products are manufactured, can be as long as three to four months, while many of our customers place orders only one month or less in advance of their requested delivery date. We have agreements with suppliers in Asia such that we are dependent on the suppliers' manufacturing yields. We continue to look at and, where feasible, establish alternative sources of supply to reduce our reliance on individual key suppliers and reduce lead times, although dual sourcing for specific products is sometimes more costly due to initial set-up costs and lower initial yields as each new manufacturing supplier ramps up production. While we have frequent communication with significant customers to review their requirements, we are restricted in our ability to react to fluctuations in demand for our products and this exposes us to the risk of having either too much or not enough of a particular product. We regularly evaluate the carrying value of inventory held. For the three months ended December 31, 2005, we recorded net reserves totaling approximately \$653,000, for inventory which we did not foresee sufficient demand to support the carrying value. An example of this would be where certain customers transitioned to next generation products more quickly than previously anticipated.

## **Global Operations**



We operate through subsidiaries and offices in several countries throughout the world. Our head office is located in Alviso (Silicon Valley), California. Our research and development resources are located in the United States, Canada and

## **Table of Contents**

India. The majority of our customers are located in Asia, supported by our sales offices in China, Japan, Singapore, South Korea, and Taiwan. Our third party suppliers are located primarily in Taiwan. Although virtually all of our revenues and costs of revenues are denominated in U.S. dollars, portions of our revenue and operating expenses are denominated in foreign currencies. Accordingly, our operating results are affected by changes in the exchange rate between the U.S. dollar and those currencies. Any future strengthening of those currencies against the U.S. dollar could negatively impact our operating results by increasing our operating expenses as measured in U.S. dollars.

We do not currently engage in any hedging or other transactions intended to manage the risks relating to foreign currency exchange rate fluctuations, other than natural hedges that occur as a result of holding both assets and liabilities denominated in foreign currencies. Our operating expenses are also affected by changes in the rate of inflation in the various countries in which we operate.

## **Mergers and Acquisitions**

Technology companies often use mergers or acquisitions to accelerate development of products, to realize potential synergies or to enter new markets. We have made significant acquisitions in the past, for example Sage Inc. in February 2002, resulting in the recording of significant intangible assets on our balance sheet.

For further details on earlier acquisitions, please refer to previously filed Annual and Quarterly Reports.

## **Critical Accounting Policies and Estimates**

The preparation of financial statements in conformity with generally accepted accounting principles requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. As described below, significant estimates are used in determining the allowance for doubtful accounts, inventory obsolescence provision, deferred income tax asset valuation, potential settlements and costs associated with patent litigation and the useful lives of intangible assets. We evaluate our estimates on an on-going basis, including those related to product returns, bad debts, inventories, investments, intangible assets, income taxes, warranty obligations and litigation and other contingencies. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

We believe the following critical accounting policies affect our more significant judgments and estimates used in the preparation of our financial statements:

We record estimated reductions to revenue for customer returns based on historical experience. A customer has a right to return products only if the product is faulty or upon termination of a distributor agreement, although in certain circumstances we agree to accept returns if replacement orders are placed for other products or to maintain our business relationship. If actual customer returns increase, we may be required to recognize additional reductions to revenue.

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We record the estimated future cost of replacing faulty product as an increase to cost of revenues. To date we have not experienced significant returns related to quality. If returns increase as a result of changes in product quality, we may be required to recognize additional warranty expense.

We maintain allowances for estimated losses resulting from the inability of our customers to make required payments. If the financial condition of our customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required. We have not suffered any significant loss in this area.

We provide for inventory obsolescence reserves against our inventory for estimated obsolescence or unmarketable inventory 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 those we project, additional inventory valuation reserves may be required.

**Table of Contents**

We provide for costs associated with settling litigation when we believe that we have a reasonable basis for estimating those costs. If actual costs associated with settling litigation differ from our estimates, we may be required to recognize additional costs.

Goodwill, which represents the excess of cost over the fair value of net assets acquired in business combinations, is tested annually for impairment, and is tested for impairment more frequently if events and circumstances indicate that the goodwill might be impaired. The impairment tests are performed in accordance with FASB Statement of Financial Accounting Standards No. 142, *Goodwill and Other Intangible Assets*. Accordingly, an impairment loss is recognized to the extent that the carrying amount of goodwill exceeds its implied fair value. This determination is made at the reporting unit level. We have assigned all goodwill to a single, enterprise-level reporting unit. The impairment test consists of two steps. First, we determine the fair value of the reporting unit. The fair value is then compared to its carrying amount. Second, if the carrying amount of the reporting unit exceeds its fair value, an impairment loss is recognized for any excess of the carrying amount of the reporting unit's goodwill over the implied fair value of that goodwill. The implied fair value of goodwill is determined by allocating the fair value of the reporting unit in a manner similar to a purchase price allocation in accordance with FASB Statement of Financial Accounting Standards No. 141, *Business Combinations*. The residual fair value after this allocation is the implied fair value of the reporting unit goodwill. We perform our annual impairment test on January 1st of each year.

We did not record any goodwill impairment charges in the nine months ended December 31, 2005, or during fiscal 2005 or 2004. Goodwill balances may also be affected by changes in other estimates made at the time of acquisitions.

We record a valuation allowance to reduce our deferred tax assets to the amount that we believe is more likely than not to be realized. Should we determine that we will not be able to realize all or part of our gross deferred tax asset, an adjustment to the deferred tax asset would be charged to income in the period such determination was made. In making this determination, we project taxable income by jurisdiction for the next three years based on market assumptions and company plans, and other jurisdictional history.

**RESULTS OF OPERATIONS****THREE MONTHS ENDED DECEMBER 31, 2005****REVENUE AND GROSS PROFIT**

The following table shows unaudited statement of operations data for the three months ended December 31, 2005 and December 31, 2004 (in thousands):

	<b>Three months ended December 31</b>	
	<b>2005</b>	<b>2004</b>
Total revenue	\$ 73,965	\$ 48,286
Gross profit	36,155	21,677
Gross profit percentage	48.9%	44.9%
Revenue by geography:		
United States	\$ 393	\$ 2,474

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China	31,964	17,870
Europe	10,104	2,716
Japan	7,537	3,744
South Korea	13,722	12,756
Taiwan	8,059	7,141
Rest of world	2,186	1,585
	<u>          </u>	<u>          </u>
Total revenue	\$ 73,965	\$ 48,286
	<u>          </u>	<u>          </u>

**Total Revenues**

Revenues for the three months ended December 31, 2005 increased by 53.2% to \$74.0 million from \$48.3 million for the three months ended December 31, 2004, primarily

## **Table of Contents**

due to higher unit shipments. Total unit shipments increased by 57.5%, while average selling prices ( ASPs ) on a consolidated basis decreased by 3% when compared to the three months ended December 31, 2004. This relatively small decline in ASPs on a consolidated basis primarily reflects the increasing proportion of TV controllers as a percentage of total revenue, which have higher ASPs than monitor products.

Since both monitor and television display devices can use the same Genesis chip, we do not always know in which type of end product our chip is being used. However, we estimate that units shipped into the LCD monitor market, which includes MFMs that can operate both as TVs and monitors, increased by 43.4%, while shipments into the TV/video market increased by more than 100% on a year over year basis. We estimate that the year over year increase in shipments of specifically flat-panel TV controller products increased by more than 117%, resulting from the overall market demand increase for flat-panel televisions.

For our monitor products, ASPs decreased by approximately 20% for the three months ended December 31, 2005 from the same period in the prior year, reflecting product transitions and competition driving companies to design lower-priced and cost-efficient next generation products. ASPs increased 4% in the TV/video market for the three months ended December 31, 2005 from the same period in the prior year, as higher-priced, feature-rich products such as GM1501, GM1601 and FLI8532 increased volume during the last twelve months. ASP increases are not expected to continue as the market expands and competition increases.

Revenues from shipments into displays with video capability, such as flat-panel televisions, continue to become a larger proportion of total revenue. During the three months ended December 31, 2005, we estimate that approximately 60% of total revenue was from consumer TV/video related products, compared with 46% for the three months ended December 31, 2004.

We have seen strong competition in all sectors of the market, and we expect this to continue. While we experienced sequential ASP declines of only 2% in our monitor products on a part for part basis during the December quarter, mix changes accounted for a further 9% decline, as newer generation products are priced lower to maintain competitive advantage in the market place. As for higher-end display controllers with TV/video capability, we believe there remains considerable opportunity to add features and reduce system cost through further integration.

The majority of our revenue continued to be to customers located in Asia. Revenue from Japan increased as the advanced television market maintained significant growth, and revenue from China increased as customers continue to manufacture more significant volumes in that country. Revenue from Europe increased due to increased sales of TV controllers needed to support the growing European flat-panel TV market, while revenue from the United States decreased primarily due to the discontinuance of the Faroudja box business, as discussed earlier.

## **Gross Profit**

Gross profit for the three months ended December 31, 2005 increased to \$36.2 million from \$21.7 million for the three months ended December 31, 2004. As a percentage of revenues, gross profit represented 48.9% of revenues for the three months ended December 31, 2005, compared with 44.9% for the three months ended December 31, 2004. The improvement in gross margin percentage is attributable to lower product costs, improvements in production yields, and an increased volume of higher margin TV/video products sold.

## **OPERATING EXPENSES**

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Management focuses on particular operating expenses in evaluating our financial condition and operating performance. The following table presents these expenses in the form reviewed by management. Significant trends and fluctuations between periods are addressed in the narrative which follows. In order to evaluate operating performance, management internally reports operating expenses in categories of a cash, non-cash, and non-recurring nature. Non-cash expenses such as the amortization of intangible assets and stock-based compensation are reviewed separately from other operating expenses. Management finds this presentation to be a more effective method of assessing current operating performance.

**Table of Contents**

	Three months ended			
	December 31, 2005		December 31, 2004	
		% of		% of
	\$000	Revenue	\$000	Revenue
Research and development	\$ 11,738	15.9%	\$ 8,916	18.5%
Selling, general and administrative	11,935	16.1%	12,161	25.2%
Amortization of acquired intangibles	2,654	3.6%	2,654	5.5%
Stock-based compensation	361	0.5%	2,465	5.1%
<b>Total operating expenses</b>	<b>\$ 26,688</b>	<b>36.1%</b>	<b>\$ 26,196</b>	<b>54.3%</b>

**Research and Development**

Research and development expenses include costs associated with research and development personnel, development tools, hardware and software licenses, and prototyping. We changed our allocation methodology on a go forward basis, beginning with the three month period ended June 30, 2005. In order to more appropriately classify expenses consistent with their activity, we have retroactively re-classified certain expenses that were previously classified in the selling, general and administrative expenses to research and development expenses. The reclassification is primarily related to costs associated with our application engineers whose work is more related to product development activities which are included in research and development activities. The impact of this reclassification increased research and development expense and reduced selling, general and administrative expenses by approximately \$2.1 million in the three months ended December 31, 2005 and by approximately \$1.4 million for the three months ended December 31, 2004. We have reclassified these expenses for the prior period presented in our financial statements for comparability.

Research and development expenses for the three months ended December 31, 2005 were \$11.7 million, compared with \$8.9 million in the three months ended December 31, 2004. This 32% increase was primarily due to higher labor-related costs as we continued to invest more in the research and development of technologies addressing the television and video markets, especially in the development of our digital TV technology, and investment in licensed technology and software tools.

These expenses represented 15.9% of revenues in the three months ended December 31, 2005, and 18.5% in the three months ended December 31, 2004.

**Selling, General and Administrative**

Selling, general and administrative expenses for the three months ended December 31, 2005, after the change in presentation described above, were \$11.9 million, compared with \$12.2 million in the three months ended December 31, 2004. The decrease primarily relates to lower costs associated with patent litigation which was partially offset by increases in labor related costs.



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These expenses represented 16.1% of revenues in the three months ended December 31, 2005 and 25.2% in the three months ended December 31, 2004.

### **Amortization of Acquired Intangibles**

Amortization of acquired intangible assets was \$2.7 million for the three months ended December 31, 2005 and 2004.

### **Stock-Based Compensation**

During the three months ended December 31, 2005, restricted stock units ( RSU ) were issued to employees as part of a new stock-based incentive program. The intrinsic value of these units is being amortized to expense over the vesting period of the

## **Table of Contents**

awards, which is typically four years. The expense is categorized in the statement of operations in accordance with the nature of the service provided by the related employees. The expense for the three months ended December 31, 2005 was \$361,000. This compares to \$2.5 million of stock-based compensation for the three months ended December 31, 2004, of which \$1.9 million resulted from the modification of option grants to certain executives during the quarter as part of their separation agreements, and \$0.5 million related to the accounting for the acquisition of Sage in February 2002, where the intrinsic value of unvested options issued in exchange for previously issued Sage options, was being amortized to expense over the remaining term of the options. This amortization period ended during the period ended September 30, 2005.

## **Total Operating Expenses**

Total operating expenses for the three months ended December 31, 2005 were \$26.7 million, representing an increase of \$0.5 million from \$26.2 million in the three months ended December 31, 2004, for the reasons described above.

## **NON OPERATING INCOME AND EXPENSES**

### **Provision for Income Taxes**

We recorded an income tax provision of \$3.6 million for the three months ended December 31, 2005 compared to a recovery of income taxes of \$3.0 million for the three months ended December 31, 2004. The increase in the income tax provision was primarily driven by higher profitability in the three months ended December 31, 2005. The significant income tax recovery for the three months ended December 31, 2004 was primarily driven by the impact of the strengthening of the Canadian dollar, which increased the value of the Canadian dollar denominated tax attributes. Our accounting effective tax rate typically differs from the expected statutory rates due to several permanent differences including, but not limited to, research and experimental development tax credits, stock-based compensation expense, foreign exchange fluctuations on the U.S. dollar working capital balances of foreign subsidiaries, and differences in tax rates in foreign jurisdictions. Any net tax benefit of these items is partially offset by changes in the valuation allowance against net operating loss carry forwards. A valuation allowance is recorded to the extent that it is more likely than not that some portion of the deferred tax assets will not be realized. Historically, the majority, if not all of the valuation allowance in the financial statements has been against the tax attributes in the United States. Therefore, the effective tax rate will continue to be directly impacted by the mix of earnings between the United States and foreign jurisdictions.

## **NINE MONTHS ENDED DECEMBER 31, 2005**

### **REVENUE AND GROSS PROFIT**

The following table shows unaudited statement of operations data for the nine months ended December 31, 2005 and December 31, 2004 (in thousands):

**Nine months ended  
December 31**

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	<u>2005</u>	<u>2004</u>
Total revenue	\$ 208,644	\$ 151,210
Gross profit	97,091	64,094
Gross profit percentage	46.5%	42.4%
Revenue by geography:		
United States	\$ 3,103	\$ 6,588
China	91,183	61,027
Europe	23,232	9,281
Japan	22,016	10,909
South Korea	39,274	36,725
Taiwan	21,158	22,390
Rest of world	8,678	4,290
Total revenue	<u>\$ 208,644</u>	<u>\$ 151,210</u>

**Table of Contents****Total Revenues**

Revenues for the nine months ended December 31, 2005 increased by 38% to \$208.6 million from \$151.2 million for the nine months ended December 31, 2004, primarily due to higher unit shipments. Total unit shipments increased by 37%, while ASPs on a consolidated basis was flat when compared to the nine months ended December 31, 2004.

We estimate that units shipped into the LCD monitor market increased by 25% while shipments into the TV/video market increased by 84% on a year over year basis. On a product basis, ASPs declined 11% in the monitor market and 4% in the TV/video market. We estimate that shipments of flat-panel TV controller products increased by 100%.

We estimate that approximately 56% of total revenue was from consumer TV/video related products for the nine months ended December 31, 2005, compared with 46% for the nine months ended December 31, 2004.

**Gross Profit**

Gross profit for the nine months ended December 31, 2005 increased to \$97 million from \$64 million for the nine months ended December 31, 2004. As a percentage of revenues, gross profit represented 46.5% of revenues for the nine months ended December 31, 2005, compared with 42.4% for the nine months ended December 31, 2004. The improvement in gross margin percentage is attributable to lower product costs, improvements in production yields, and an increased percentage of higher margin TV/video products sold.

**OPERATING EXPENSES**

As with the discussion of the three month period earlier in this MD&A, the following table presents operating expenses for the nine month periods ended December 31, 2005 and December 31, 2004 in the form reviewed by management.

	Nine months ended			
	December 31, 2005		December 31, 2004	
	\$000	% of Revenue	\$000	% of Revenue
Research and development	\$ 32,605	15.6%	\$ 27,067	17.9%
Selling, general and administrative	34,668	16.6%	32,475	21.5%
Amortization of acquired intangibles	7,962	3.8%	7,962	5.3%
Stock-based compensation	652	.3%	4,062	2.7%
<b>Total operating expenses</b>	<b>\$ 75,887</b>	<b>36.3%</b>	<b>\$ 71,566</b>	<b>47.4%</b>

### **Research and Development**

Research and development expenses for the nine months ended December 31, 2005 were \$32.6 million, compared with \$27.1 million in the nine months ended December 31, 2004. This 20% increase was primarily due to higher labor-related costs due to increased headcount. The impact of the change in allocation methodology discussed earlier was to increase research and development expense and reduce selling, general and administrative expenses by approximately \$5.2 million in the nine months ended December 31, 2005 and by approximately \$4 million for the nine months ended December 31, 2004.

These expenses represented 15.6% of revenues in the nine months ended December 31, 2005, and 17.9% in the nine months ended December 31, 2004.

### **Selling, General and Administrative**

Selling, general and administrative expenses for the nine months ended December 31, 2005, after the change in presentation described above, were \$34.7 million, compared

## **Table of Contents**

with \$32.5 million in the nine months ended December 31, 2004. This higher expense was primarily due to increased headcount and an increase in compensation costs related to higher revenue and profitability.

These expenses represented 16.6% of revenues in the nine months ended December 31, 2005 and 21.5% in the nine months ended December 31, 2004.

### **Amortization of Acquired Intangibles**

Amortization of acquired intangible assets was \$8.0 million for the nine months ended December 31, 2005 and 2004.

### **Stock-Based Compensation**

Amortization of deferred stock-based compensation amounted to \$0.7 million for the nine months ended December 31, 2005, compared to \$4.1 million for the nine months ended December 31, 2004.

### **Total Operating Expenses**

Total operating expenses for the nine months ended December 31, 2005 were \$75.9 million, representing an increase of \$4.3 million from \$71.6 million in the nine months ended December 31, 2004, for the reasons described above.

## **NON OPERATING INCOME AND EXPENSES**

### **Provision for Income Taxes**

We recorded an income tax provision of \$6.0 million for the nine months ended December 31, 2005 compared to an income tax benefit of \$3.6 million for the nine months ended December 31, 2004. As with the three month period, higher profitability during the nine month period resulted in a higher income tax charge. This increase was also offset in part by the impact of the strength of the Canadian dollar, which increased the value of the Canadian dollar denominated tax attributes.

## **LIQUIDITY AND CAPITAL RESOURCES**

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Since inception we have satisfied our liquidity needs primarily through cash generated from operations and sales of equity securities, initially by way of a public offering, and subsequently under our stock option and employee stock purchase plans. We believe that our existing cash balances together with any cash generated from our operations will be sufficient to meet our capital and operating requirements for the foreseeable future.

Periodically, we may be required to use a portion of our cash balances to increase investment in operating assets such as accounts receivable or inventory to assist in the growth of our business. We may make additional investments through the licensing or acquisition of technology, or in capital assets such as land, buildings or equipment. Furthermore, because we do not have our own semiconductor manufacturing facility, we may be required to make deposits to secure supply in the event there is a shortage of manufacturing capacity in the future. While we currently have no plans to raise additional funds for such uses, we could be required or could elect to seek to raise additional capital in the future.

From time to time we evaluate acquisitions of businesses, products or technologies that are complementary or strategic to our business. Any such transactions, if consummated, may use a portion of our working capital or require the issuance of equity securities that may result in further dilution to our existing stockholders.

	<b>December 31, 2005</b>	<b>March 31, 2005</b>
	<u>                    </u>	<u>                    </u>
Cash, cash equivalents and short-term investments	\$ 175,215	\$ 129,757
Working capital	\$ 209,242	\$ 156,411
Current ratio	7.29	6.84
Receivables days outstanding	46	52
Inventory turnover days	56	51

**Table of Contents**

At December 31, 2005, cash equivalents and short-term investments totaled \$175.2 million compared with \$129.8 million at March 31, 2005. Our current ratio at December 31, 2005 was 7.29 compared to 6.84 at March 31, 2005. We have no debt and we continue to generate cash from operations during fiscal 2006. Net cash provided by operating activities was \$29.8 million for the nine months ended December 31, 2005 compared with \$15.8 million for the nine months ended December 31, 2004.

Working capital sources of cash related primarily to increases in accrued liabilities, while these were more than offset by uses of cash due to the increase in accounts receivable and inventory balances. Accounts receivable increased by \$6.9 million from March 31, 2005 to December 31, 2005, resulting from higher revenues during the period, while days sales outstanding ( DSO ) decreased to 46 days at December 31, 2005 from 52 days at March 31, 2005. While DSO s decreased during the quarter, this trend is unlikely to continue as we may extend payment terms to certain key customers, as we compete with the terms offered by our competition and as our key customers feel pressure from their own customers to provide more favorable payment terms. Also, as our customers become more established in China, we are becoming more comfortable with extending credit. Our credit policy is to offer credit to customers only after examination of their creditworthiness. Our payment terms range from cash in advance of shipment, to payment ninety days after shipment. For the nine months ended December 31, 2005, our three largest customers accounted for 35% of revenue, compared with 33% for the nine months ended December 31, 2004. Additionally, the top three customers accounted for 39% of accounts receivable at December 31, 2005 and 37% at March 31, 2005. Inventory levels increased by 32% from March 31, 2005 to \$23.2 million from 17.6 million, primarily resulting from the increased production to support future revenue growth. Average days of inventory on hand at December 31, 2005 increased to 56 days, compared to 51 days at March 31, 2005. The average inventory levels and inventory turns is impacted by a number of dynamic activities including the accuracy of customer forecasts, expected panel supplies, and pricing considerations. These activities are not necessarily an indication of what inventory turns might be in the future.

Net cash used in investing activities was \$71.6 million during the nine months ended December 31, 2005, compared with cash used in investing activities of \$0.9 million during the nine months ended December 31, 2004. This increase was primarily due to the purchase of short-term investments during the nine months ended December 31, 2005.

Net cash provided by financing activities was \$25.3 million for the nine months ended December 31, 2005, and \$5.2 million for the three months ended December 31, 2004. These represent funds received for the purchase of shares under the terms of our stock option plans.

**Contractual Obligations**

As of December 31, 2005, our principal commitments consisted of obligations outstanding under operating leases. These commitments include leases for three premises in the United States, located in San Jose and Alviso, California, and one location in each of Canada, India, China, Japan, Singapore, South Korea and Taiwan. In addition, we have obligations under operating leases for equipment. The aggregate minimum annual payments required under our lease obligations, excluding expected sub-lease income, by fiscal year are as follows (in thousands):

	PAYMENTS DUE BY FISCAL YEAR					
	TOTAL	2006	2007	2008	2009	2010
Operating Leases	\$ 10,284	\$ 4,058	\$ 3,105	\$ 1,533	\$ 1,380	\$ 208

Our lease agreements expire at various dates through calendar 2009.



Purchase orders or contracts for the purchase of raw material and other goods and services have not been separately disclosed. We are not able to determine the aggregate amount of such purchase orders that represent contractual obligations, as

## **Table of Contents**

purchase orders may represent authorizations to purchase rather than binding agreements. Our purchase orders for manufacturing are based on our current needs and are fulfilled by our vendors within short time horizons. We do not have significant agreements for the purchase of raw materials or other goods specifying minimum quantities or set prices that exceed our expected requirements for three months. We also enter into contracts for outsourced services; however, the obligations under these contracts are not significant and the contracts generally contain clauses allowing for cancellation without significant penalty.

## **Off-Balance Sheet Arrangements**

We do not have any off-balance sheet arrangements that have or are reasonably likely to have a material current or future effect on our financial condition, revenue or expenses, results of operations, liquidity, capital expenditures or capital resources.

## **Capital commitments**

We do not have any capital commitments that will have a material future effect on our financial condition.

## **RISK FACTORS**

**Our quarterly revenues and operating results fluctuate due to a variety of factors, which may result in volatility or a decline in our stock price.**

Our historical revenues and operating results have varied significantly from quarter to quarter. Moreover, our actual or projected operating results for some quarters may not meet the expectations of stock market analysts and investors, which may cause our stock price to decline. In addition to the factors discussed elsewhere in this Risk Factors section, a number of factors may cause our revenue to fall short of our expectations or cause fluctuations in our operating results, including:

Our ability to gain design wins with our customers and ramp new designs into production volumes;

Growth rate of the flat-panel TV and LCD monitor markets;

Seasonal consumer demand for flat-panel TVs and LCD monitors into which our products are incorporated;

Customer inventory levels;

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Changes in the mix of products we sell, especially as between our higher-priced TV/video products and our lower-priced monitor products, and as between our legacy two-chip solutions and newer one-chip solutions;

Increased competition and competitive pricing pressures;

Availability and pricing of panels and other components for flat-panel TVs and LCD monitors;

Wafer costs and other product fabrication costs;

Foreign exchange rate fluctuations, research and development tax credits and other factors that impact tax rates;

Changes in product costs or manufacturing yields or available production capacity at our fabrication facilities;

U.S. Customs enforcement of the ITC Exclusion Order against display controllers that infringe Genesis Microchip's U.S. patent No. 5,739,867 and LCD monitors containing infringing parts; and

Costs and outcome of legal proceedings.

As a result of the fluctuation in our revenues and operating results, our stock price can be volatile, especially if our actual financial performance in a quarter deviates from the financial targets we set at the beginning of that quarter, or from market expectations.

## **Table of Contents**

### **Our success will depend on the growth of the market for flat panel televisions and LCD monitors.**

Our ability to generate revenues will depend on the growth of the market for flat-panel televisions, LCD computer monitors, and digital televisions. Our continued growth will also depend upon emerging markets for consumer electronics markets such as HDTV. The potential size of these markets and the timing of their development are uncertain and will depend in particular upon:

A continued reduction in the costs of products in the respective markets;

The availability, at a reasonable price, of components required by such products (such as LCD panels); and

The emergence of competing technologies and standards.

These and other potential markets may not develop as expected, which would harm our business.

### **We must develop new products and enhance our existing products to react to rapid technological change and market demands.**

We must develop new products and enhance our existing products with improved technologies to meet rapidly evolving customer requirements and industry standards. In addition, we are developing products for digital television, which is a nascent market and a new application for our display technology. We cannot assure you that we will be able to transition our current technology to meet the demands of the digital television market.

We need to design products for customers that continually require higher functionality at lower costs. We must, therefore, continue to add features to our products and to include all of these features on a single chip. The development process for these advancements is lengthy and will require us to accurately anticipate technological innovations and market trends. Developing and enhancing these products is time-consuming, costly and complex.

There is a risk that these developments and enhancements will be late, fail to meet customer or market specifications, and will not be competitive with other products using alternative technologies that offer comparable functionality. We may be unable to successfully develop new products or product enhancements. Any new products or product enhancements may not be accepted in new or existing markets. If we fail to develop and introduce new products or product enhancements, that failure will harm our business.

### **We face intense competition and may not be able to compete effectively.**

The markets in which we operate are intensely competitive and are characterized by technological change, evolving industry standards and rapidly declining average selling prices. We compete with both large and small companies, including ATI Technologies, Broadcom Corp., Intel Corp., LSI Logic Corp., Micronas Semiconductor Holding AG, Mediatek Corp., Mstar Semiconductor, Inc., Novatek Microelectronics, Philips

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Semiconductors, a division of Philips Electronics N.V., Pixelworks, Inc., Realtek Semiconductor Corp., Silicon Image, Inc., ST Microelectronics, Inc., Trident Microsystems, Inc., and Zoran Corporation. In addition, many of our current and potential customers have their own internally developed integrated circuit solutions, and may choose not to purchase solutions from third party suppliers like Genesis.

As the markets for our products continue to develop, our current customers may increase reliance on their own internally developed solutions, and competition from diversified electronic and semiconductor companies will intensify. Some competitors, who may include our own customers, are likely to include companies with greater financial and other resources than we have. Our overseas competitors have reduced cost structures that enable them to compete aggressively on price. Increased competition could harm our business, by, for example, increasing pressure on our profit margins or causing us to lose customers. Also, the federal district court for the Eastern District of Virginia has issued an amended final judgment which states that we have received a license from Silicon Image, Inc. for certain of their DVI and HDMI patents, and must pay Silicon Image royalties on all of our DVI and HDMI products. This amended final judgment, if not overturned on appeal, could hinder our ability to compete with unlicensed competitors that are not required to pay royalties on competing products.

## **Table of Contents**

### **Our customers experience fluctuating product cycles and seasonality, which causes their sales to fluctuate.**

Our products are incorporated into flat panel displays. Because the market for flat panel displays is characterized by numerous new product introductions, our operating results may vary significantly from quarter to quarter. Our customers also experience seasonality in the sales of their products, which affects their orders of our products. Typically, the second half of the calendar year represents a disproportionate percentage of sales for our customers due to the holiday shopping period for these products, and therefore, a disproportionate percentage of our sales. Also, our sales in the first quarter of the calendar year may be lower as a result of the Chinese New Year holiday in Asia. We expect these sales fluctuations to continue for the foreseeable future.

### **A loss of any of our major customers could have a significant impact on our business.**

The markets for our products are highly concentrated. Our sales are derived from a limited number of customers. Sales to our largest five customers accounted for 49% of our revenues, and for our largest customer 15%, for the three months ended December 31, 2005. We expect that a small number of customers will continue to account for a large amount of our revenues. The decision by any large customer to decrease or cease using our products could harm our business. In addition, our customers sell to a limited number of original equipment manufacturers (OEMs). The decision by any large OEM to decrease or cease using our customer's products could, in turn, cause our customer to decrease or cease buying from us. Most of our sales are made on the basis of purchase orders rather than long-term agreements so that any customer could cease purchasing products at any time without penalty.

### **We must sell our current products in greater volumes, or introduce new products with improved margins.**

Average selling prices for our products have declined, in many cases dramatically. When average selling prices decline, our revenues decline unless we are able to sell more units, and our gross margin dollars decline unless we are able to reduce our manufacturing and/or other supply chain costs by a commensurate amount. We therefore need to sell our current products in greater volumes to offset the decline in their ASPs, while also introduce new products that have improved gross margins.

### **Intellectual property infringement suits brought against us or our customers may significantly harm our business.**

We defended claims brought against us by Silicon Image, Inc., alleging that certain of our products that contain digital receivers infringe various Silicon Image patent claims. In addition, IP Innovation LLC has sued Dell Computer Corporation, alleging patent infringement by certain of its consumer and/or professional electronics products, including some that contain our display controller products. This lawsuit, or any future patent infringement lawsuits, could subject us to permanent injunctions preventing us from selling the accused products and/or cause us to incur significant costs, including defense costs, settlements and judgments. In addition, as a result of this lawsuit or any future patent infringement lawsuits, our existing customers may decide to stop buying our products, and prospective customers may be unwilling to buy our products.

Intellectual property lawsuits, regardless of their success, would likely be time-consuming and expensive to resolve and would divert management time and attention.

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In addition, if we are unsuccessful and our products (or our customers' monitors or televisions that contain our products) are found to infringe the intellectual property rights of others, we could be forced to do one or more of the following:

Stop selling the products or using the technology that contain the allegedly infringing intellectual property;

## **Table of Contents**

Attempt to obtain a license to the relevant intellectual property, which license may not be available on reasonable terms or at all;

Incur substantial costs including defense costs, settlements and/or judgments; and

Attempt to redesign those products that contain the allegedly infringing intellectual property.

As a result, intellectual property litigation could have a material adverse effect on our revenues, financial results and market share.

### **We may be required to indemnify our customers against claims of intellectual property infringement.**

From time to time, we enter into agreements with our customers that contain indemnification provisions for claims based on infringement of third party intellectual property rights. As a result, if such a claim based on our products is made against an indemnified customer, we may be required under our indemnification obligations to defend or settle the litigation, and/or to reimburse that customer for its costs, including defense costs, settlements and judgments. We may also be subject to claims for indemnification under statutory or common law. For example, some of our customers have requested assistance and indemnification in connection with lawsuits or threatened lawsuits by IP Innovation LLC against Dell Computer Corporation and other consumer electronics companies alleging patent infringement by various products that may contain our display controller products. This or other patent litigation and any indemnification obligations we may have could have a material adverse effect on our revenues, financial results and market share, and could result in significant payments by us that could have a material adverse effect on our financial position.

### **We may be unable to adequately protect our intellectual property. We rely on a combination of patent, copyright, trademark and trade secret laws, as well as non-disclosure agreements and other methods to protect our proprietary technologies.**

We have been issued patents and have pending United States and foreign patent applications. However, we cannot assure you that any patent will be issued as a result of any applications or, if issued, that any claims allowed will be sufficiently broad to protect our technology. It may be possible for a third party to copy or otherwise obtain and use our products, or technology without authorization, develop similar technology independently or design around our patents. Effective patent, copyright, trademark and trade secret protection may be unavailable or limited in foreign countries. In addition, it is possible that existing or future patents, or even court rulings in our favor regarding our patents, may be challenged, invalidated or circumvented. For example, U.S. Customs has declined to apply our ITC exclusion order to MStar's Tsunami (or TSU) products; see Part II: Other Information Item 1, Legal Proceedings.

### **Our products require licenses of third-party technology that may not be available to us on reasonable terms, or at all.**

We license technology from third parties that is incorporated into our products. Future products or product enhancements may require additional third-party licenses, which may not be available to us on commercially reasonable terms, or at all. We also license third-party intellectual property in order to comply with display technology standards. For example, we signed the DVI Adopters Agreement and the HDMI Adopters Agreement in order to obtain a license to those standards. However, even though we licensed the DVI technology, Silicon Image, Inc., one of the promoters of the DVI standard, sued us for allegedly infringing certain DVI patents. If we are unable to obtain third-party licenses required to develop new products and product enhancements, or to comply with applicable standards, we could be at competitive disadvantage.





## **Table of Contents**

### **We may become subject to judgments for securities class action suits.**

We are a defendant in a securities class action suit. In July 2005, the court granted Genesis's motion to dismiss the case with prejudice, but the plaintiffs have filed for an appeal. We believe that we have meritorious defenses to the claims in the securities class action suit as well as adequate insurance coverage to cover any likely unfavorable outcome. However, this or any future securities class action suit could subject us to judgments in excess of our insurance coverage and could harm our business. In addition, this kind of lawsuit, regardless of its outcome, is likely to be time-consuming and expensive to resolve and may divert management time and resources.

### **The processes used to manufacture our semiconductor products are periodically retired.**

As semiconductor manufacturing technologies advance, manufacturers typically retire their older manufacturing processes in favor of newer processes. When this occurs, the manufacturer generally provides notice to its customers of its intent to discontinue a process, and its customers will either retire the affected part or design a newer version of the part that can be manufactured on the more advanced process. Consequently, our products may become unavailable from their current manufacturers if the processes on which they are produced are discontinued. Our devices are mainly 0.18, and 0.16 micron technology and these geometries will likely be available for the next two to three years. We must manage the transition to new parts from existing parts. We have commitments from our suppliers to provide notice of any discontinuance of their manufacturing processes in order to assist us in managing these types of product transitions.

### **Our semiconductor products are complex and are difficult to manufacture cost-effectively.**

The manufacture of semiconductors is a complex process. It is often difficult for semiconductor foundries to achieve acceptable product yields. Product yields depend on both our product design and the manufacturing process technology unique to the semiconductor foundry. Since low yields may result from either design or process difficulties, identifying yield problems can only occur well into the production cycle, when a product exists which can be physically analyzed and tested.

### **Defects in our products could increase our costs, cause customer claims, and delay our product shipments.**

Although we test our products, they are complex and may contain defects and errors. In the past we have encountered defects and errors in our products. Delivery of products with defects or reliability, quality or compatibility problems may damage our reputation and our ability to retain existing customers and attract new customers. In addition, product defects and errors could result in additional development costs, diversion of technical resources, delayed product shipments, increased product returns, and product liability claims against us which may not be fully covered by insurance. Any of these could harm our business.

### **We subcontract our manufacturing, assembly and test operations.**

We do not have our own fabrication facilities, assembly or testing operations. Instead, we rely on others to fabricate, assemble and test all of our products. Most of our products use silicon wafers manufactured by Taiwan Semiconductor Manufacturing Corporation, the loss of which could

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result in a material increase in the price we must pay for silicon wafers. There are many risks associated with our dependence upon outside manufacturing, including:

Reduced control over manufacturing and delivery schedules of products;

Political or environmental risks (including earthquake and other natural disasters) in Taiwan, where the manufacturing facilities are located;

Reduced control over quality assurance and reliability;

Increased manufacturing cost to us in the event that manufacturing capacity becomes constrained;

Difficulty of management of manufacturing costs and quantities;

Potential lack of adequate capacity during periods of excess demand; and

Potential misappropriation of intellectual property.

## **Table of Contents**

We depend upon outside manufacturers to fabricate silicon wafers on which our integrated circuits are imprinted. These wafers must be of acceptable quality and in sufficient quantity and the manufacturers must deliver them to assembly and testing subcontractors on time for packaging into final products. We have at times experienced delivery delays and long manufacturing lead times. These manufacturers fabricate, test and assemble products for other companies. We cannot be sure that our manufacturers will devote adequate resources to the production of our products or deliver sufficient quantities of finished products to us on time or at an acceptable cost. The lead-time necessary to establish strategic relationships with new manufacturing partners is considerable. We would be unable to readily obtain an alternative source of supply for any of our products if this proves necessary. Any occurrence of these manufacturing difficulties could harm our business or cause us to incur costs to obtain adequate and timely supply of products.

**We do not have long-term commitments from our customers, and we allocate resources based on our estimates of customer demand.**

Our sales are made on the basis of purchase orders rather than long-term purchase commitments. In addition, our customers may cancel or defer purchase orders. We manufacture our products according to our estimates of customer demand. This process requires us to make multiple demand forecast assumptions, each of which may introduce error into our estimates. If we overestimate customer demand, we may manufacture products that we may not be able to sell. As a result, we would have excess inventory, which would increase our losses. Conversely, if we underestimate customer demand or if sufficient manufacturing capacity were unavailable, we would forego revenue opportunities, lose market share and damage our customer relationships.

**Our lengthy sales cycle can result in uncertainty and delays in generating revenues.**

Because our products are based on new technology and standards, a lengthy sales process, typically requiring several months or more, is often required before potential customers begin the technical evaluation of our products. This technical evaluation can then exceed nine months. It can take an additional nine months before a customer commences volume shipments of systems that incorporate our products. However, even when a manufacturer decides to design our products into its systems, the manufacturer may never ship systems incorporating our products. Given our lengthy sales cycle, we experience a delay between the time we increase expenditures for research and development, sales and marketing efforts and inventory and the time we generate revenues, if any, from these expenditures. As a result, our business could be harmed if a significant customer reduces or delays its orders or chooses not to release products incorporating our products.

**A large percentage of our revenues will come from sales outside of the United States, which creates additional business risks.**

A large portion of our revenues will come from sales to customers outside of the United States, particularly to equipment manufacturers located in South Korea, China, Japan and Taiwan. For the three months ended December 31, 2005, sales to regions outside of the United States represented 99% of revenues. For that same period, sales to China and South Korea alone constituted 43% and 19%, respectively. These sales are subject to numerous risks, including:

Fluctuations in currency exchange rates, tariffs, import restrictions and other trade barriers;

Unexpected changes in regulatory requirements;

Political and economic instability;

Exposure to litigation or government investigations in these countries;

Longer payment periods;

Ability to enforce contracts or payment terms;

Potentially adverse tax consequences;

Export license requirements; and

Unexpected changes in diplomatic and trade relationships.

Because our sales are denominated in United States dollars, increases in the value of the United States dollar could increase the price of our products in non-U.S. markets and may make our products more expensive than competitors' products denominated in local currencies.

## **Table of Contents**

### **We are subject to risks associated with international operations, which may harm our business.**

We depend on product design groups located outside of the United States, primarily in Canada and India. We also rely on foreign third-party manufacturing, assembly and testing operations. These foreign operations subject us to a number of risks associated with conducting business outside of the United States, including the following:

Unexpected changes in, or impositions of, legislative or regulatory requirements;

Delays resulting from difficulty in obtaining export licenses for certain technology, tariffs, quotas and other trade barriers and restrictions;

Imposition of additional taxes and penalties;

The burdens of complying with a variety of foreign laws; and

Other factors beyond our control, including acts of terrorism, which may delay the shipment of our products, impair our ability to travel or our ability to communicate with foreign locations.

In addition, the laws of certain foreign countries in which our products are or may be designed, manufactured or sold may not protect our products or intellectual property rights to the same extent as the laws of the United States. This increases the possibility of piracy of our technology and products.

### **The cyclical nature of the semiconductor industry may lead to significant variances in the demand for our products.**

In the past, significant downturns and wide fluctuations in supply and demand have characterized the semiconductor industry. Also, the industry has experienced significant fluctuations in anticipation of changes in general economic conditions, including economic conditions in Asia. These cycles have led to significant variances in product demand and production capacity. They have also accelerated the erosion of average selling prices per unit. We may experience periodic fluctuations in our future financial results because of changes in industry-wide conditions.

### **A breakdown in our information technology systems could cause a business interruption, impair our ability to manage our business or report results, or result in the unauthorized disclosure of our confidential and proprietary information.**

Our information technology systems could suffer a sudden breakdown as a result of factors beyond our control, such as earthquakes, insecure connections or problems with our outside consultants who provide information technology services to us. If our information technology systems were to fail and we were not able to gain timely access to adequate alternative systems or back-up information, this could have a negative impact on our ability to operate and manage our business and to report results in a timely manner. Also, any breach of our information systems by an unauthorized third party could result in our confidential information being made public or being used by a competitor, which could have a material adverse effect on our ability to realize the potential of our proprietary rights.

**We may make acquisitions where advisable, and acquisitions involve numerous risks.**

Our growth is dependent upon market growth and our ability to enhance our existing products and introduce new products on a timely basis. One of the ways we may address the need to develop new products is through acquisitions of other companies or technologies, such as our acquisitions of Sage and the assets of VM Labs. These acquisitions and potential future acquisitions involve numerous risks, including the following:

We may experience difficulty in assimilating the acquired operations and employees;

We may be unable to retain the key employees of the acquired operations;

The acquisitions may disrupt our ongoing business;

## **Table of Contents**

We may not be able to incorporate successfully the acquired technologies and operations into our business and maintain uniform standards, controls, policies and procedures; and

We may lack the experience to enter into new markets, products or technologies.

Acquisitions of high-technology companies are inherently risky, and no assurance can be given that our recent or potential future acquisitions will be successful and will not adversely affect our business, operating results or financial condition. We must also maintain our ability to manage growth effectively. Failure to manage growth effectively and successfully integrate acquisitions made by us could materially harm our business and operating results.

### **We need to continually evaluate internal financial controls against evolving standards.**

The Sarbanes-Oxley Act of 2002 and newly proposed or enacted rules and regulations of the Securities and Exchange Commission and the National Association of Securities Dealers impose new duties on us and our executives, directors, attorneys and independent registered public accountants. In order to comply with the Sarbanes-Oxley Act and such new rules and regulations, we have evaluated our internal controls systems to allow management to report on, and our independent auditors to attest to, our internal controls. As a result, we have incurred additional expenses for internal and outside legal, accounting and advisory services, which have increased our operating expenses and accordingly reduce our net income or increase our net losses. While we have met the requirements of Section 404 including the evaluation, documentation and testing of internal controls for the year ended March 31, 2005, we cannot be certain as to the future outcome of our testing and resulting remediation actions or the impact of the same on our operations. We have an ongoing program to perform the system and process evaluation and testing necessary to comply with these requirements and we expect to continue to incur significant expenses in connection with this process. In the event that our chief executive officer, chief financial officer or independent registered public accounting firm determine in the future that our internal controls over financial reporting are not effective as defined under Section 404, investor perceptions may be adversely affected and could cause a decline in the market price of our stock. In addition, current regulatory standards are subject to change, and additional standards may be imposed.

### **General economic conditions may reduce our revenues and harm our business.**

As our business has grown, we have become increasingly subject to the risks arising from adverse changes in domestic and global economic conditions. Because of the recent economic slowdown, many industries are delaying or reducing technology purchases. As a result, if economic conditions in the United States, Asia or Europe worsen, or if a wider or global economic slowdown occurs, reduced orders and shipments may cause us to fall short of our revenue expectations for any given period and may result in us carrying increased inventory. These conditions would negatively affect our business and results of operations. If our inventory builds up as a result of order postponement, we would carry excess inventory that is either unusable or that must be sold at reduced prices which will harm our revenues. In addition, weakness in the technology market could negatively affect the cash flow of our customers who could, in turn, delay paying their obligations to us. This would increase our credit risk exposure, which could harm our financial condition.

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

We are exposed to financial market risks including changes in interest rates and foreign currency exchange rates.



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The fair value of our investment portfolio or related income would not be significantly impacted by either a 10% increase or decrease in interest rates due mainly to the short-term nature of the major portion of our investment portfolio.

We carry out a significant portion of our operations outside of the United States, primarily in Canada and in India and to a lesser extent China, Japan, South Korea, Singapore and Taiwan. Although virtually all of our revenues and costs of revenues are denominated in U.S. dollars, portions of our operating revenue and expenses are

## **Table of Contents**

denominated in foreign currencies. Accordingly, our operating results are affected by changes in the exchange rate between the U.S. dollar and those currencies. Any future strengthening of those currencies against the U.S. dollar could negatively impact our operating results by increasing our operating expenses as measured in U.S. dollars. We do not currently engage in any hedging or other transactions intended to manage the risks relating to foreign currency exchange rate fluctuations, other than natural hedges that occur as a result of holding both assets and liabilities denominated in foreign currencies. We may, in the future, undertake hedging or other such transactions, if we determine it is necessary to offset exchange rate risks. Based on our overall currency rate exposure at December 31, 2005 and March 31, 2005, a near-term 10% appreciation or depreciation in the U.S. dollar relative to a pool of our foreign currencies would not have a material effect on our operating expenses or financial condition. However, we do have Canadian dollar denominated tax attributes represented by a deferred income tax asset on the condensed consolidated balance sheet. A near-term 10% appreciation in the U.S. dollar relative to the Canadian dollar would increase our income tax expense by approximately \$3 million.

## **ITEM 4. CONTROLS AND PROCEDURES**

### **Evaluation of disclosure controls and procedures**

Our management evaluated, with the participation of our Chief Executive Officer and our Chief Financial Officer, the effectiveness of our disclosure controls and procedures as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on this evaluation, our Chief Executive Officer and our Chief Financial Officer have concluded that our disclosure controls and procedures are effective to ensure that information we are required to disclose in reports that we file or submit under the Securities Exchange Act of 1934 is accumulated and communicated to our management, including our principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure, and that such information is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms.

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

### **Changes in internal control over financial reporting**

There was no change in our internal control over financial reporting that occurred during the period covered by this Quarterly Report on Form 10-Q that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## **PART II: OTHER INFORMATION**

### **ITEM 1. LEGAL PROCEEDINGS**

Mstar Litigation

Genesis filed a patent infringement complaint against MStar Semiconductor, Inc. ( Mstar ) and other respondents in the U.S. International Trade Commission ( ITC ). In August 2004, the ITC determined that MStar and the other respondents infringe Genesis 's patent, and issued an exclusion order preventing the importation of MStar 's and the other respondents ' infringing display controllers into the United States, as well as LCD monitors and boards containing these products. However, U.S. Customs has declined to enforce the ITC 's exclusion order against MStar 's Tsunami (or TSU) products. In December 2004, Mstar filed an appeal of the exclusion order and related ITC rulings to the Federal Circuit Court of Appeals. The other respondents did not appeal.

**Table of Contents**

The future financial impact of this dispute is not determinable and no provision has been made in our consolidated financial statements for any future costs or settlements associated with these claims.

**ITEM 6. EXHIBITS****(a) Exhibits****Exhibit**

<b>Number</b>	<b>Exhibit Description</b>
2.1(1)	Agreement and Plan of Merger and Reorganization, dated as of September 27, 2001, by and between Genesis Microchip Incorporated and Sage, Inc.
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10.3(6)*	Offer of employment to James E. Donegan dated June 25, 2002.
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10.9(9)*	Separation Agreement and Release with Chandrashekar Reddy.
10.10(9)*	Consulting Agreement with Chandrashekar Reddy.
10.11(8)*	1987 Stock Option Plan.
10.12(8)*	1997 Employee Stock Option Plan.
10.13(9)*	1997 Employee Stock Purchase Plan, as last amended on September 17, 2002.
10.14(8)*	1997 Non-Employee Stock Option Plan.
10.15(8)*	2000 Nonstatutory Stock Option Plan.

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10.16(8)*	2001 Nonstatutory Stock Option Plan.
10.17(8)*	Paradise Electronics, Inc. 1997 Employee Stock Option Plan.
10.18(8)*	Sage, Inc. Second Amended and Restated 1997 Stock Plan.
10.19(9)*	2001 Employee Stock Purchase Loan Plan (for non-officers).
10.20(9)	Lease Termination Agreement with 1601 McCarthy Boulevard, L.L.C. regarding premises located in Milpitas, California.
10.21(12)*	Settlement Agreement and Release with James E. Donegan.
10.22(10)	Termination and Release Agreement, dated as of August 5, 2003, among Genesis Microchip Inc., Display Acquisition Corporation and Pixelworks, Inc.
10.23(11)*	Offer Letter with Michael Healy.
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**Table of Contents**

10.26(14)*	Interim CEO Employment Agreement with Eric Erdman.
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10.28(13)*	2003 Stock Plan.
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10.31(15)*	Form of 2000 Nonstatutory Stock Option Plan Stock Option Agreement for China
10.32(16)*	Amendment No.1 to Separation Agreement and Release with Chandrashekar Reddy, dated November 10, 2004.
10.33(17)*	Offer Letter of Employment with Elias Antoun, dated November 10, 2004.
10.34(18)*	Change in Control Severance Agreement with Elias Antoun, dated November 29, 2004.
10.35(19)*	Separation Agreement and Release with Eric Erdman, dated December 3, 2004.
10.36(19)*	Consulting Agreement with Eric Erdman, dated December 3, 2004.
10.37(20)*	Separation Agreement and Release with Young Ahn, dated December 28, 2004.
10.38*(21)	1997 Employee Stock Option Plan, as amended on September 19, 2005, and form of Notice of Grant of Restricted Stock Units.
10.39*(21)	2000 Nonstatutory Stock Option Plan, as amended on September 19, 2005.
21(9)	Subsidiaries.
31.1	Certification of Chief Executive Officer, as required by Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934.
31.2	Certification of Chief Financial Officer, as required by Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934.
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- (1) Incorporated by reference to the Registrant's Registration Statement on Form S-4 (File No. 333-72202) filed with the Securities and Exchange Commission on October 25, 2001, as amended.
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  - (5) Incorporated by reference to Faroudja Laboratories, Inc.'s Form S-1 (File No. 333-32375) filed with the Securities and Exchange Commission on July 30, 1997, as amended.
  - (6) Incorporated by reference to the Registrant's Quarterly Report on Form 10-Q filed with the Securities and Exchange Commission on August 14, 2002.
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  - (9) Incorporated by reference to the Registrant's Annual Report on Form 10-K filed with the Securities Exchange Commission on June 20, 2003.

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**Table of Contents**

- (10) Incorporated by reference to the Registrant's Current Report on Form 8-K filed with the Securities Exchange Commission on August 6, 2003.
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  - (21) Incorporated by reference to the Registrant's Quarterly Report on Form 10-Q filed with the Securities Exchange Commission on November 8, 2005.
- \* Identifies a management contract or compensatory plan of arrangement required to be filed as an exhibit to this report pursuant to Item 14(c) of this report.

**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.

GENESIS MICROCHIP INC.

By: /s/ MICHAEL E. HEALY

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Michael E. Healy  
Chief Financial Officer  
(Authorized Officer to sign on behalf of Registrant &  
Principal Financial Officer)

Date: February 8, 2006

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