CONEXANT SYSTEMS INC
Form 10-Q
August 16, 2004

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

FORM 10-Q

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

For the quarterly period ended June 30, 2004*

OR

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

Commission file number: 000-24923

CONEXANT SYSTEMS, INC.

(Exact name of registrant as specified in its charter)

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

100 Schulz Drive
Red Bank, New Jersey 07701
(Address of principal executive offices) (Zip code)

(732) 345-7500
(Registrant s telephone number, including area code)

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

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

Number of shares of registrant s common stock outstanding as of July 30, 2004 was 468,764,918.

* For presentation purposes of this Form 10-Q, references made to the June 30, 2004 period relate to the actual fiscal third quarter ended July 2, 2004.

Table of Contents

CAUTIONARY STATEMENT

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

2

CONEXANT SYSTEMS, INC.

INDEX

		PAGE
PART I. FINANCIAL INFORMATION		
Item 1.	Financial Statements (unaudited):	
	Consolidated Condensed Balance Sheets June 30, 2004 and September 30, 2003	4
	Consolidated Condensed Statements of Operations Three and Nine Months Ended June 30, 2004 and 2003	5
	Consolidated Condensed Statements of Cash Flows Nine Months Ended June 30, 2004 and 2003	6
	Notes to Consolidated Condensed Financial Statements	7
Item 2.	Management s Discussion and Analysis of Financial Condition and Results of Operations	24
Item 3.	Quantitative and Qualitative Disclosures About Market Risk	44
Item 4.	Controls and Procedures	45
PART II. OTHER INFORMATION		
Item 2.	Changes in Equity Securities, Use of Proceeds and Issuer Purchases of Equity Securities	46
Item 6.	Exhibits and Reports on Form 8-K	46
	Signature	47

EXHIBIT 31.1
EXHIBIT 31.2
EXHIBIT 32

3

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

CONEXANT SYSTEMS, INC.

Consolidated Condensed Balance Sheets
(unaudited, in thousands, except per share amounts)

	June 30, 2004	September 30, 2003
ASSETS		
Current assets:		
Cash and cash equivalents	$ 78,549	$ 76,186
Short-term investments	158,293	99,283
Receivables, net of allowance of $1,258 and $1,547 at June 30, 2004 and September 30, 2003, respectively	213,904	79,557
Inventories	145,551	59,548
Deferred income taxes	13,631	13,600
Mindspeed warrant-current portion	11,700	
Other current assets	31,828	26,524
Total current assets	653,456	354,698
Property, plant and equipment, net	84,251	36,310
Goodwill	705,689	56,865
Intangible assets, net	143,393	12,506
Deferred income taxes	242,445	241,260
Mindspeed warrant	69,151	119,230
Marketable securities	188,045	
Other assets	133,083	110,838
Total assets	$ 2,219,513	$ 931,707
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 128,211	$ 55,909
Accrued compensation and benefits	49,584	28,865
Restructuring and reorganization liabilities	20,798	12,091
Other current liabilities	68,111	24,816
Total current liabilities	266,704	121,681
Convertible subordinated notes	711,825	581,825
Other liabilities	74,436	61,435

Total liabilities	1,052,965	764,941
Commitments and contingencies		
Shareholders equity:		
Preferred and junior preferred stock		
Common stock, $0.01 par value: 1,000,000 shares authorized; 466,315 and 276,134 shares issued, and 465,665 shares and 276,134 shares outstanding at June 30, 2004 and September 30, 2003, respectively	4,663	2,761
Treasury stock: 650 shares at cost	(4,778)	
Additional paid-in capital	4,643,743	3,506,070
Accumulated deficit	(3,506,685)	(3,332,527)
Accumulated other comprehensive income (loss)	58,723	(9,496)
Notes receivable from stock sales	(2,292)	
Unearned compensation	(26,826)	(42)
Total shareholders equity	1,166,548	166,766
Total liabilities and shareholders equity	$ 2,219,513	$ 931,707

See accompanying notes to consolidated condensed financial statements.

Table of Contents

CONEXANT SYSTEMS, INC.

Consolidated Condensed Statements of Operations
(unaudited, in thousands, except per share amounts)

	Three months ended June 30,		Nine months ended June 30,	
	2004	**2003**	**2004**	**2003**
Net revenues	$267,617	$150,950	$ 688,731	$ 435,274
Cost of goods sold (including $812 for the nine months ended June 30, 2004 related to restructuring actions in the merger-Notes 3 and 7)	155,136	86,000	395,448	245,569
Gross margin	112,481	64,950	293,283	189,705
Operating expenses:				
Research and development (including non-cash stock compensation of $2,237 and $3,131 for the three and nine months ended June 30, 2004, respectively, and $45 and $444 for the three and nine months ended June 30, 2003, respectively)	74,317	38,849	167,205	117,827
Selling, general and administrative (including non-cash stock compensation of $743 and $1,029 for the three and nine months ended June 30, 2004, and $0 and $1,272 for the three and nine months ended June 30, 2003, respectively)	36,371	22,915	89,782	69,471
Amortization of intangible assets	7,956	925	12,564	2,523
In-process research and development			160,818	
Special charges	8,294	6,526	14,413	13,585
Total operating expenses	126,938	69,215	444,782	203,406
Operating loss	(14,457)	(4,265)	(151,499)	(13,701)
Gain on extinguishment of debt		(7,376)		(42,021)
Other (income) expense, net	56,308	(544)	21,291	40,785
Income (loss) before income taxes	(70,765)	3,655	(172,790)	(12,465)
Provision for income taxes	661	488	1,368	1,185

Income (loss) from continuing operations	(71,426)	3,167	(174,158)	(13,650)
Loss from discontinued operations, net of income taxes		(52,297)		(728,877)
Net loss	$ (71,426)	$ (49,130)	$ (174,158)	$ (742,527)
Income (loss) per share, basic:				
Continuing operations	$ (0.15)	$ 0.01	$ (0.48)	$ (0.05)
Discontinued operations		(0.19)		(2.73)
Net loss	$ (0.15)	$ (0.18)	$ (0.48)	$ (2.78)
Income (loss) per share, diluted:				
Continuing operations	$ (0.15)	$ 0.01	$ (0.48)	$ (0.05)
Discontinued operations		(0.19)		(2.73)
Net loss	$ (0.15)	$ (0.18)	$ (0.48)	$ (2.78)
Number of shares used in per share computation-basic	463,804	268,469	363,654	266,915
Number of shares used in per share computation-diluted	463,804	271,051	363,654	266,915

See accompanying notes to consolidated condensed financial statements.

Table of Contents

CONEXANT SYSTEMS, INC.

Consolidated Condensed Statements of Cash Flows
(unaudited, in thousands)

	Nine months ended June 30,	
	2004	**2003**
Cash flows from operating activities:		
Loss from continuing operations	$(174,158)	$ (13,650)
Adjustments to reconcile loss from continuing operations to net cash provided by (used in) operating activities, net of effects of disposition of business and acquisitions:		
Depreciation	11,337	13,576
Amortization of intangible assets	12,564	2,523
In-process research and development	160,818	
Asset impairments	4,534	8,092
Provision for losses on accounts receivable		(3,912)
Inventory provisions	6,046	12,597
Decrease in fair value of Skyworks note and Mindspeed warrant	44,671	76
Write-down of non-marketable investments	600	34,402
Equity in (earnings) losses of equity method investees	(12,750)	3,233
Gain of extinguishment of debt		(42,021)
Gain of sale of investments	(27,017)	(5,228)
Other non-cash items, net	7,334	8,148
Changes in assets and liabilities:		
Receivables	(42,174)	(22,410)
Inventories	(18,631)	(16,238)
Accounts payable	30,131	(4,974)
Accrued expenses and other current liabilities	8,942	1,157
Other	(10,589)	5,612
Net cash provided by (used in) operating activities	1,658	(19,017)
Cash flows from investing activities:		
Cash received in (paid for) acquisitions, net	24,752	(6,796)
Payment of acquisition related costs	(29,764)	
Advances to Skyworks		(35,000)
Repayment of Term Notes and advances by Skyworks		170,000
Purchases of marketable securities	(67,816)	(73,511)
Sales of marketable securities	38,384	132,900
Capital expenditures	(13,922)	(13,555)
Proceeds from sales of assets and investments	31,580	15,378
Payment of deferred purchase consideration	(4,000)	
Investments in businesses	(2,619)	(4,500)

Net cash provided by (used in) investing activities	(23,405)	184,916
Cash flows from financing activities:		
Proceeds from exercise of stock options	24,110	7,275
Repurchase of convertible subordinated notes		(56,378)
Net cash provided by (used in) financing activities	24,110	(49,103)
Net cash used in discontinued operations		(202,971)
Net increase (decrease) in cash and cash equivalents	2,363	(86,175)
Cash and cash equivalents at beginning of period	76,186	161,088
Cash and cash equivalents at end of period	$ 78,549	$ 74,913

See accompanying notes to consolidated condensed financial statements.

CONEXANT SYSTEMS, INC.

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS
(unaudited)

1. Basis of Presentation and Significant Accounting Policies

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

On February 27, 2004, Conexant completed its merger with GlobespanVirata, Inc. (GlobespanVirata), a provider of broadband communications solutions for consumer, enterprise and service provider markets. Following the merger, GlobespanVirata is a wholly-owned subsidiary of Conexant. In the merger, GlobespanVirata shareholders received 1.198 shares of Conexant common stock for each share of GlobespanVirata common stock and Conexant issued approximately 180.6 million shares. In addition, the outstanding and unexercised common stock options of GlobespanVirata were adjusted and converted into options to purchase 43.6 million shares of Conexant common stock. See Note 2 for further information.

On June 27, 2003, Conexant completed the distribution to Conexant shareholders of all outstanding shares of Mindspeed Technologies, Inc. (Mindspeed), a wholly owned subsidiary of Conexant to which Conexant contributed its Internet infrastructure business, including the stock of certain subsidiaries, and certain other assets and liabilities, including approximately $100.0 million in cash (hereinafter, the Mindspeed Spin). In the Mindspeed Spin, Conexant shareholders received one share of Mindspeed common stock for every three Conexant shares held and the Conexant shareholders continued to hold their Conexant shares. Mindspeed issued to Conexant a warrant to purchase 30.0 million shares of Mindspeed common stock, representing approximately 20 percent of Mindspeed s outstanding common stock on a fully diluted basis at the time of the Mindspeed Spin. The warrant is exercisable for a period of ten years, commencing one year after the completion of the Mindspeed Spin, at an exercise price of $3.408 per share (the fair market value on the date of grant). The warrant is recorded as an asset on the consolidated condensed balance sheet (see Note 3) and changes in the estimated fair value of the warrant are recorded in other (income) expense. Additionally, Conexant entered into a senior secured revolving credit facility pursuant to which Mindspeed may borrow up to $50.0 million for working capital and general corporate purposes. See Note 10 for further information.

The operating results of the discontinued Mindspeed Technologies Internet infrastructure business (through June 27, 2003) included in the accompanying unaudited consolidated condensed statements of operations were as follows (in thousands):

	Three months ended June 30,	Nine months ended June 30,

	2003	2003
Net revenues	$ 20,153	$ 58,719
Loss before income taxes	$(52,095)	$(155,231)
Provision for income taxes	202	462
Cumulative effect of change in accounting for goodwill		(573,184)
Loss from discontinued operations	$(52,297)	$(728,877)

Interim Reporting In the opinion of management, the accompanying unaudited consolidated condensed financial statements contain all adjustments, consisting of adjustments of a normal recurring nature, as well as the special charges, necessary to present fairly the Company s financial position, results of operations and cash flows. The results of operations for interim periods are not necessarily indicative of the results that may be expected for a full

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

year. These statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company s Annual Report on Form 10-K for the fiscal year ended September 30, 2003.

Fiscal Periods For presentation purposes, references made to the periods ended June 30, 2004 and 2003 relate to the actual fiscal 2004 third quarter ended July 2, 2004 and the actual fiscal 2003 third quarter ended June 27, 2003, respectively.

Supplemental Cash Flow Information Cash paid for interest was $16.6 million and $15.6 million for the nine months ended June 30, 2004 and 2003, respectively. Cash paid for income taxes for the nine months ended June 30, 2004 and 2003 was $0.2 million and $1.8 million, respectively. See Note 2 for a discussion of the common stock and options issued and net assets acquired in acquisitions.

Loss Per Share Basic loss per share is based on the weighted-average number of shares of common stock outstanding during the period. Diluted loss per share also includes the effect of stock options and other common stock equivalents outstanding during the period, and assumes the conversion of the Company s convertible subordinated notes for the period of time such notes were outstanding, if such stock options and convertible notes are dilutive. In periods of a net loss position, basic and diluted weighted average shares are the same.

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

	Three months ended June 30,		Nine months ended June 30,	
	2004	**2003**	**2004**	**2003**
Numerator (dollars in thousands):				
Income (loss) from continuing operations	$ (71,426)	$ 3,167	$(174,158)	$ (13,650)
Loss from discontinued operations, net of income taxes		(52,297)		(728,877)
Net loss	$ (71,426)	$ (49,130)	$(174,158)	$(742,527)
Denominator (weighted-average number of shares in thousands):				
Weighted average shares outstanding- basic	463,804	268,489	363,654	266,915
Stock options and warrants (under the treasury stock method)		2,562		
Weighted average shares outstanding - diluted	463,804	271,051	363,654	266,915

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

	Three months ended June 30,		Nine months ended June 30,	
(weighted-average number of shares, in thousands)	**2004**	**2003**	**2004**	**2003**
Stock options and warrants (under the treasury stock method)	21,734		24,239	1,150
4.25% Convertible Subordinated Notes due 2006	7,364	5,962	7,364	5,918
4% Convertible Subordinated Notes due 2007	12,137	9,859	12,137	10,902
5.25% Convertible Subordinated Notes due 2006	5,840		2,695	
Restricted stock	10		15	81

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

Table of Contents

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

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

	Three months ended June 30,		Nine months ended June 30,	
	2004	2003	2004	2003
Income (loss) from continuing operations, as reported	$(71,426)	$ 3,167	$(174,158)	$(13,650)
Add: expense determined under fair value accounting included in loss from continuing operations, as reported	2,980	45	4,160	1,716
Deduct: total expense determined under fair value accounting for all awards	(18,693)	(11,040)	(43,071)	(46,519)
Pro forma loss from continuing operations	$(87,139)	$ (7,828)	$(213,069)	$(58,453)
Income (loss) from continuing operations per share basic, as reported	$ (0.15)	$ 0.01	$ (0.48)	$ (0.05)
Pro forma loss from continuing operations per share basic	$ (0.19)	$ (0.03)	$ (0.59)	$ (0.22)
Income (loss) from continuing operations per share diluted, as reported	$ (0.15)	$ 0.01	$ (0.48)	$ (0.05)
Pro forma loss from continuing operations per share diluted	$ (0.19)	$ (0.03)	$ (0.59)	$ (0.22)

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

	Three months ended June 30,		Nine months ended June 30,	
	2004	2003	2004	2003
Risk-free interest rate	3.93%	3.18%	3.33%	3.18%
Expected volatility	97%	97%	97%	97%

Dividend yield				
Expected life (years)	4.5	4.5	2.5 4.5	4.5
Weighted-average fair value of options granted	$3.63	$2.02	$5.04	$1.33

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

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

Equity securities included in short-term marketable securities represent the Company s common stock holdings in publicly traded companies and are classified as short-term based on the Company s ability and intent to liquidate the securities as necessary to meet liquidity requirements. The reported fair value of these equity securities is based on

Table of Contents

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

the quoted market prices of the securities at each reporting date. Based on the overall state of the stock market, the availability of buyers for the shares when the Company wants to sell, and other restrictions, at any point in time the amounts ultimately realized upon liquidation of these securities may be significantly different than the carrying value.

Total cash, cash equivalents and marketable securities at June 30, 2004 and at September 30, 2003 are as follows (in thousands):

	June 30, 2004	September 30, 2003
Cash and cash equivalents	$ 78,549	$ 76,186
Skyworks 15% convertible senior subordinated notes		55,566
Equity securities- Skyworks Solutions, Inc. (6.2 million shares at June 30, 2004, 0.5 million shares at September 30, 2003)	50,824	4,576
Equity securities- SiRF Technologies, Inc. (5.9 million shares at June 30, 2004)	74,582	
Other short-term marketable securities (primarily U.S. government agencies and corporate debt securities)	32,887	39,141
Subtotal- short-term investments	158,293	99,283
Long-term marketable securities (primarily U.S. government agencies and corporate debt securities)	188,045	
	$424,887	$175,469

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

Reclassifications Certain prior year amounts have been reclassified to conform to the current year presentation.

2. Acquisitions

Merger with GlobespanVirata, Inc.

On February 27, 2004, the Company completed its merger with GlobespanVirata, with GlobespanVirata becoming a wholly-owned subsidiary of the Company. For accounting purposes, the transaction was accounted for under the

purchase method of accounting with the Company as the acquiror. In exchange for 100% of the outstanding shares of common stock of GlobespanVirata (approximately 150.7 million shares), the Company issued 1.198 shares of Conexant common stock for each share of GlobespanVirata common stock outstanding (or approximately 180.6 million shares of Conexant common stock) and each outstanding option and warrant to purchase GlobespanVirata common stock was adjusted and converted into an option or warrant to purchase Conexant common stock based on the 1.198 merger ratio (or approximately 43.6 million options to purchase shares of Conexant common stock). In May 2004, the GlobespanVirata, Inc. subsidiary was renamed Conexant, Inc., and hereinafter will be referred to as Conexant, Inc., and the overall business combination is hereinafter referred to as the Merger.

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

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

The fair value of Conexant common stock and stock options issued of $1.1 billion has been allocated to common stock and additional paid in capital. The fair market value of the 180.6 million shares of common stock issued was determined using a per share price of $5.69 (the average of the closing market prices of Conexant common stock on the day of the announcement of the Merger, November 3, 2003, and on the three business days before and after the announcement date). In accordance with FASB Interpretation No. 44 Accounting for Certain Transactions Involving Stock Compensation , the $111.9 million fair value of the 43.6 million Conexant common stock options granted to replace the acquired common stock options was determined using a Black-Scholes option pricing model with the following assumptions: market price of $5.69 per share, volatility of 97%, risk-free rate of return of 3.2%, expected lives of 4.5 years and no dividend yield. Approximately $30.9 million in intrinsic value associated with

Table of Contents

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

the unvested stock options has been allocated to unearned compensation and will be amortized to expense over the average remaining vesting period of approximately 2.6 years. A total of $3.0 million and $4.1 million of this unearned compensation was recognized as an expense in the three and nine months ended June 30, 2004, respectively.

In connection with the Merger, the Company began to formulate a reorganization and restructuring plan (the Reorganization Plan). As a result of the Reorganization Plan, the Company recorded restructuring and asset impairment charges related to Conexant s operations of $6.1 million and $9.4 million during the three and nine months ended June 30, 2004, respectively. These charges are included in Special Charges and Cost of Goods Sold in the accompanying consolidated condensed statement of operations. Additionally, the Company initially recognized $14.8 million as liabilities assumed in the purchase business combination related to restructuring liabilities for estimated costs related to Conexant, Inc. facilities consolidation and the related impact on Conexant, Inc. outstanding real estate leases and Conexant, Inc. involuntary employee terminations and relocations. In the quarter ended June 30, 2004, these liabilities were reduced by $3.6 million against the purchase price allocation (goodwill) for certain facilities related decisions. These liabilities were included in the allocation of the purchase price in accordance with SFAS No. 141 entitled Business Combinations and EITF 95-3 entitled Recognition of Liabilities in Connection with a Purchase Business Combination . Finalization and execution of the Reorganization Plan is not yet complete and further actions may be taken such as additional or different facilities impairments, workforce reductions or relocations and/or product related decisions with respect to duplicate technology licenses, duplicate maintenance contracts, production masks and inventory of goods for which there will no longer be an active market for the combined company. The Reorganization Plan and its related actions are expected to be completed by the end of calendar 2004, and when taken, charges and/or reductions will be recorded as an adjustment to goodwill. Any actions relating to the acquiring corporation will be charged against operations. See Note 7 for a further description of the Company s reorganization and restructuring plans.

The following sets forth the Company s estimates of the fair values of the assets acquired and liabilities assumed in the Merger as of February 27, 2004 (in thousands). These amounts have been adjusted for the $3.6 million Reorganization Plan changes described above, and other liability reductions totaling $2.4 million. The amounts below may change further as the Reorganization Plan is completed.

Cash and cash equivalents	$ 42,515
Short-term and long-term investments	153,099
Accounts receivable	91,259
Inventories	73,281
Prepaids and other current assets	4,056
Property and equipment	46,883
Other long-term assets	20,600
Identifiable intangible assets	137,931
In-process research and development	160,818
Goodwill	629,387
Accounts payable	(41,580)
Accrued expenses	(75,062)
Accrued restructuring and reorganization liabilities	(11,255)
Long-term debt	(130,000)
Other long-term liabilities	(23,284)

Treasury stock	9,188
Notes receivable from stock sales	2,469
Unearned compensation	30,948
Net assets acquired	$1,121,253

Table of Contents

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

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

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

The identifiable intangible assets were valued using the income approach and a discount rate of 18%. The developed technologies consist of eight products in the digital subscriber line (DSL) and wireless local area network (LAN) categories. Under the income approach, the fair value reflects the present value of the projected cash flows that are expected to be generated by the products incorporating the current technology. The type of income approach utilized for the trademark was the relief from royalty methodology, under which an estimate is made as to the appropriate royalty income that would be negotiated in an arm s length transaction if the subject intangible asset were licensed from an independent third party owner. These assets are being amortized on a straight-line basis over their estimated useful lives ranging from 2 to 7 years, with a weighted-average life of approximately 5 years. Amortization expense for these intangible assets was $6.9 million and $9.6 million for the three and nine months ended June 30, 2004, respectively. The amount recorded as goodwill of $629.4 million is not deductible for tax purposes.

The amount allocated to in process research and development (IPR&D) of $160.8 million was expensed upon completion of the Merger (as a charge not deductible for tax purposes) as it was determined that the underlying products had not reached technological feasibility, had no alternative uses and successful development was uncertain. The Company identified and valued two IPR&D projects relating to the development of DSL and wireless LAN products. The DSL project represented 70% of the total IPR&D acquired. Both projects were approximately 87% complete at the date of the merger. The estimated costs to complete for the DSL and wireless LAN projects were approximately $14.1 million and $6.2 million, respectively. These projects will be completed in fiscal 2005. The fair values assigned to these projects were based on the income approach and used projected cash flows which were discounted at a rate of 19%. The discount rate was derived from a weighted-average cost of capital analysis, adjusted upwards to reflect additional risks inherent in the development process, including the probability of achieving technological success and market acceptance. Each of the IPR&D projects was analyzed considering technological innovations, the existence and utilization of core technology, the complexity, costs and time to complete the remaining development efforts, and stage of completion. The discount rate reflects the stage of completion and other risks inherent in the projects. The material risks associated with the incomplete projects are the ability to complete the items within the outlined timeframes and within the allocated cost guidelines, and ultimately to sell the products to end-users.

Management is responsible for the amounts determined for IPR&D as well as developed technologies and believes that that amounts are representative of fair values. Through June 30, 2004, actual results do not materially differ from the estimates used in the valuations of IPR&D or developed technologies.

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

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

	Three months ended June 30,	**Nine months ended June, 30**	
	2003	**2004**	**2003**
Net revenues	$225,325	$ 875,507	$ 629,459
Net loss	$ (62,799)	$(198,051)	$(803,475)
Net loss per common share basic and diluted	$ (0.14)	$ (0.43)	$ (1.80)

12

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

The pro forma results are based on various assumptions and are not necessarily indicative of what would have occurred had the merger closed on October 1, 2003 and 2002, respectively.

Acquisition of Amphion Semiconductor

On June 29, 2004, the Company purchased all the outstanding capital stock of Amphion Semiconductor Limited (Amphion), a company located in Belfast, Northern Ireland specializing in developing video compression technology. The Company completed this strategic acquisition as a complement to existing products. The consideration for this purchase was $20.0 million in cash, 600,000 shares of common stock (valued at $6.0 million) and $0.4 million in transaction costs. Net tangible assets acquired were $2.6 million. The excess of the purchase price over the net tangible assets was assigned to developed technology of $4.2 million and $19.6 million to goodwill. The developed technology will be amortized on a straight-line basis over five years. The amount recorded as goodwill of $19.6 million is not deductible for tax purposes. The purchase price allocation is preliminary and is subject to change.

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

The terms of this acquisition include provisions under which the former shareholders of Amphion could receive additional consideration of up to $4.0 million during the twelve to eighteen months following the acquisition if certain technology milestones are achieved. This contingent consideration has not been included in the purchase price allocation and if earned, such amounts will be capitalized as an addition to goodwill.

The pro forma effect of this acquisition was not material to the Company s results of operations for fiscal 2004 or 2003.

3. Supplemental Financial Statement Data

Marketable Securities

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

Short-term investments (in thousands):	**Amortized Cost**	**Gross Unrealized Holding Gains**	**Gross Unrealized Holding Losses**	**Fair Value**

June 30, 2004:				
U.S. government agencies	$28,138	$	$ (91)	$ 28,047
Foreign government securities	502			502
Corporate debt securities	1,797		(16)	1,781
Equity securities	57,374	72,289	(1,700)	127,963
	$87,811	$72,289	$(1,807)	$158,293
September 30, 2003:				
Skyworks 15% convertible senior subordinated notes	$46,542	$ 9,024	$	$ 55,566
U.S. government agencies	14,640	25	(18)	14,647
Foreign government securities	2,044	15		2,059
Corporate debt securities	21,625	74	(59)	21,640
Equity securities	2,320	3,051		5,371
	$87,171	$12,189	$ (77)	$ 99,283

Table of Contents

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

The Company accounted for the Skyworks 15% convertible senior subordinated notes as available-for-sale securities carried at their fair value. Unrealized gains or losses resulting from changes in the fair value of the underlying debt were included in other comprehensive income. The right to convert the Skyworks 15% convertible senior subordinated notes into shares of Skyworks common stock was, for financial accounting purposes, an embedded derivative instrument. Changes in the fair value of the Skyworks 15% convertible senior subordinated notes resulting from changes in the value of the conversion right were included in other (income) expense, net each period. During the quarter ended June 30, 2004, the Company converted the notes into 5.7 million shares of Skyworks common stock at the conversion price of $7.87 per share (see Note 4).

Long-term investments (in thousands):	Amortized Cost	Gross Unrealized Holding Gains	Gross Unrealized Holding Losses	Fair Value
June 30, 2004:				
U.S. government agencies	$159,033	$	$(806)	$158,227
Corporate debt securities	29,974		(156)	29,818
	$189,007	$	$(962)	$188,045

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

Inventories

Inventories consist of the following (in thousands):

	June 30, 2004	September 30, 2003
Work-in-process	$ 74,629	$42,662
Finished goods	70,922	16,886
	$145,551	$59,548

In the quarter ended March 31, 2004, as a result of strategic decisions made at the time of the Merger, the Company wrote down $0.8 million of on-hand inventory products which will no longer be actively marketed or sold. This amount was charged to cost of goods sold.

Goodwill

During the first nine months of fiscal 2004, goodwill was adjusted as follows (in thousands):

Goodwill, September 30, 2003	$ 56,865
Merger	635,261
Goodwill, March 31, 2004	692,126
Adjustment to purchase price allocations	(5,999)
Acquisitions	19,562
Goodwill, June 30, 2004	$705,689

Intangible Assets

Intangible assets consist of the following (in thousands):

	June 30, 2004			September 30, 2003		
	Gross Asset	Accumulated Amortization	Net	Gross Asset	Accumulated Amortization	Net
Developed technology	$145,893	$(18,065)	$127,828	$15,904	$ (7,456)	$ 8,448
Customer base	2,050	(725)	1,325	2,050	(358)	1,692
Other intangible assets	20,908	(6,668)	14,240	7,443	(5,077)	2,366
	$168,851	$(25,458)	$143,393	$25,397	$(12,891)	$12,506

Table of Contents

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

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

	Remainder of 2004	2005	2006	2007	2008	Thereafter
Amortization expense	$ 8,206	$31,624	$29,881	$29,157	$28,714	$15,811

Mindspeed Warrant

The Company accounts for the Mindspeed warrant as a derivative instrument, and changes in the fair value of the warrant are included in other (income) expense, net each period. At June 30, 2004, the aggregate fair value of the Mindspeed warrant included on the accompanying consolidated condensed balance sheet was $80.9 million. The current portion of $11.7 million was determined using current pricing data, and the remaining portion was valued using a Black-Scholes model with terms for portions of the warrant varying from 1 to 5 years, volatility of 90%, a risk-free interest rate of 3.2% and no dividend yield. It is the Company s intent to liquidate the portion of this warrant classified as current in the next twelve months.

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

Convertible Subordinated Notes

The Company and its consolidated subsidiaries have three issues of convertible subordinated notes, including the 5.25% convertible subordinated notes due May 2006 which were acquired in the Merger. At June 30, 2004, the components of convertible subordinated notes are as follows (in thousands):

4.0% Convertible Subordinated Notes due February 2007 with a conversion price of $42.43	$515,000
4.25% Convertible Subordinated Notes due May 2006 with a conversion price of $9.08	66,825
5.25% Convertible Subordinated Notes due May 2006 with a conversion price of $22.26	130,000
Total convertible subordinated notes	$711,825

The significant terms of the 5.25% convertible subordinated notes acquired by the Company in the Merger in February 2004 are as follows: The 5.25% convertible subordinated notes are unsecured obligations of Conexant, Inc., are contractually subordinated in right of payment to all senior indebtedness of Conexant, Inc., and mature on May 15, 2006. The holders may convert the notes into shares of Conexant common stock at any time prior to maturity at a

conversion price of $22.262 per share, subject to adjustment. On and after May 20, 2004, Conexant, Inc. at its option may redeem the notes at any time, in whole or in part, at the redemption price shown in the notes, plus accrued interest, if any. Through June 30, 2004, none of the 5.25% Convertible Subordinated Notes have been redeemed.

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

Other (Income) Expense, Net

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

	Three months ended June 30,		Nine months ended June 30,	
	2004	**2003**	**2004**	**2003**
Investment and interest income	$ (1,404)	$(3,585)	$ (6,703)	$(13,134)
Decrease in fair value of Skyworks 15% convertible senior subordinated notes	17,837	76	6,292	1,832
Decrease in fair value of the Mindspeed warrant	60,924		38,379	
Interest expense	8,373	6,254	22,322	21,424
Equity in (earnings) losses of equity method investees	(1,934)	2,423	(12,750)	3,233
Gains on sales of investments	(27,017)	(5,228)	(27,017)	(5,228)
Write down of non-marketable investments			600	34,402
Other	(471)	(484)	168	(1,744)
	$ 56,308	$ (544)	$ 21,291	$ 40,785

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

During the quarter ended June 30, 2004, SiRF Technology Holdings, Inc. (SiRF) completed its initial public offering of shares of its common stock at a public offering price of $12.00 per share. The Company sold approximately 2.5 million shares in the SiRF offering for net proceeds of $28.2 million and recorded a related gain of $26.5 million, which is included in gains on sales of investments above.

4. Skyworks Notes

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

facility was cancelled and the Company released all security interests in Skyworks assets and properties.

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

5. Commitments and Contingencies

Certain claims have been asserted against the Company, including claims alleging the use of the intellectual property rights of others in certain of the Company s products. The resolution of these matters may entail the negotiation of a license agreement, a settlement, or the adjudication of such claims through arbitration or litigation.

Texas Instruments, Inc. The Company s Conexant, Inc. subsidiary has been involved in a dispute with Texas Instruments, Inc. (Texas Instruments) over a group of patents (and related foreign patents) that Texas Instruments alleges are essential to certain industry standards for implementing ADSL technology. On June 12, 2003, Conexant, Inc. filed a complaint against Texas Instruments, Stanford University and its Board of Trustees, and Stanford University OTL, LLC (collectively, the Defendants) in the U.S. District Court of New Jersey. The complaint asserts, among other things, that the Defendants have violated the antitrust laws by creating an illegal patent pool, by

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

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

Agere Systems, Inc. On October 17, 2002, Agere Systems, Inc. (Agere) filed suit against Intersil Corporation (Intersil) in the U.S. District Court of Delaware. Conexant, Inc. acquired the WLAN Group of Intersil in August 2003. Agere alleges that Intersil infringes certain of its U.S. patents. Intersil has counterclaimed against Agere for infringement of certain patents, some of which are now owned by the Company s Conexant, Inc. subsidiary and licensed to Intersil for purposes of the suit. The parties have filed a stipulated order adding Conexant, Inc. as a party to the suit. On July 22, 2003, Agere filed a separate suit against Intersil in the U.S. District Court of Delaware alleging that Intersil infringes certain additional U.S. patents. Conexant, Inc. has also been added as a party to this action. Conexant, Inc. has the benefit of an indemnity and/or warranty from Intersil which the Company believes limits Conexant, Inc. s liability for monetary damages related to these suits, but the possibility exists that the court could issue an injunction against future sales of affected wireless products. The Company believes that this litigation is unlikely to have a material adverse effect on its business, financial condition, or results of operations.

On October 30, 2002, Intersil and certain of its affiliated companies filed a suit against Agere in the U.S. District Court for the District of Philadelphia alleging that Agere misappropriated certain Media Access Control Wireless Local Area Network technology. This action seeks an injunction to prevent Agere, either alone or in cooperation with others, from developing, making, and/or selling products that use that technology. Agere has made similar counterclaims against Conexant, Inc. and its affiliated companies and Intersil and its affiliated companies. As a result of the acquisition of Intersil s WLAN Products Group and its Choice-Intersil Microsystems, Inc. subsidiary, which is a party to this suit and the only remaining plaintiff, Conexant, Inc. has become involved in this suit. Conexant, Inc. has the benefit of an indemnity and/or warranty from Intersil which the Company believes limits Conexant, Inc. s liability for monetary damages, but the possibility exists that the court could issue an injunction against future sales of affected wireless products. The Company believes that this litigation is unlikely to have a material adverse effect on its business, financial condition, or results of operations.

IPO Litigation. In November 2001, Collegeware Asset Management, LP, on behalf of itself and a putative class of persons who purchased Conexant, Inc. common stock between June 23, 1999 and December 6, 2000, filed a complaint in the U. S. District Court for the Southern District of New York alleging violations of federal securities laws by the underwriters of Conexant, Inc. s initial and secondary public offerings as well as certain Conexant, Inc.

officers and directors. The complaint alleges that the defendants violated federal securities laws by issuing and selling Conexant, Inc. s common stock in the initial and secondary offerings without disclosing to investors that the underwriters had (1) solicited and received undisclosed and excessive commissions or other compensation and (2) entered into agreements requiring certain of their customers to purchase the stock in the aftermarket at escalating prices. The complaint seeks unspecified damages. The complaint was consolidated with approximately 300 other actions making similar allegations regarding the public offerings of hundreds of other companies during 1998 through 2000. In June 2003, the issuers, the individual defendants and plaintiffs reached a tentative settlement agreement that would, among other things, result in the dismissal with prejudice of all claims against Conexant, Inc. s officers and directors. The settlement remains subject to a number of conditions, including class certification

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

and approval of the settlement by the court. It is possible that the parties will not reach agreement on the final settlement or that the settlement will not be approved. Even if the settlement is approved, individual class members will have an opportunity to opt out of the class and to file their own lawsuits, and some may do so. In either event, the Company believes that the Conexant, Inc. officers and directors have meritorious defenses to the plaintiffs claims and expects that those defendants will defend themselves vigorously. The Company also believes that it has sufficient insurance coverage to cover any indemnification obligations to the directors and officers related to this litigation.

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

The Company has been designated as a potentially responsible party and is engaged in groundwater remediation at one Superfund site located at a former silicon wafer manufacturing facility and steel fabrication plant in Parker Ford, Pennsylvania formerly occupied by the Company. In addition, the Company is engaged in remediation of groundwater contamination at its former Newport Beach, California wafer fabrication facility. Management currently estimates the aggregate remaining costs for these remediations to be approximately $3.0 million and has accrued for these costs as of June 30, 2004.

The Company leases certain facilities and equipment under non-cancelable operating leases which expire at various dates through 2021 and contain various provisions for rental adjustments including, in certain cases, adjustments based on increases in the Consumer Price Index. The leases generally contain renewal provisions for varying periods of time. Rental expense under operating leases was approximately $15.5 million and $12.5 million for the nine months ended June 30, 2004 and 2003, respectively.

At June 30, 2004, future minimum lease payments under operating leases were as follows (in thousands):

Fiscal Year	
2004 remaining 3 months	$ 7,220
2005	23,370
2006	18,563
2007	14,876
2008	11,059
Thereafter	63,431
Total future minimum lease payments	$138,519

The summary of future minimum lease payments includes an aggregate of $18.3 million of lease obligations that principally expire through fiscal 2011, which have been accrued for in connection with the Company s reorganization and restructuring actions (see Note 7).

The Company purchases a portion of its requirements for silicon-based semiconductor products from Jazz Semiconductor, Inc. (Jazz). During the first two years of the long-term supply arrangement entered into with Jazz in March 2002, the Company s cost of wafers was an amount which approximated its historical cost. Thereafter, the cost of wafers is based on market prices. Additionally, the Company is obligated to purchase certain minimum annual volumes of wafers during the first three years of the arrangement. In the event the Company s actual wafer purchases are less than the required minimum volumes, it will be required to make additional payments to Jazz. The Company s expected minimum purchase obligations under the long-term supply agreement with Jazz, net of a portion of the wafer purchase obligations assumed by a third party, will be approximately $6.6 million for the remainder of fiscal year 2004 and $13.1 million in fiscal 2005.

Table of Contents

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

Additionally, the Company entered into a long-term supply agreement with Skyworks in June 2002, under which Skyworks provides semiconductor assembly and test services at the Company s former Mexicali, Mexico facility. Under this supply agreement, the Company is obligated to purchase certain minimum amounts of assembly and test services for the remainder of fiscal 2004 and for fiscal 2005 in the amounts of $4.4 million and $10.9 million, respectively. In the event the Company s purchases of assembly and test services are less than the required minimum amounts, it will be required to make additional payments to Skyworks.

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

At June 30, 2004, the Company is contingently liable for approximately $26.7 million in operating lease commitments on facility leases that were assigned to Mindspeed and Skyworks at the time of their separation from the Company.

In connection with certain non-marketable equity investments, the Company may be required to invest up to an additional $6.2 million as of June 30, 2004.

6. Comprehensive Loss

Comprehensive loss is as follows (in thousands):

	Three months ended June 30,		Nine months ended June 30,	
	2004	**2003**	**2004**	**2003**
Net loss	$(71,426)	$(49,130)	$(174,158)	$(742,527)
Other comprehensive income (loss):				
Foreign currency translation adjustments	(556)	700	346	1,327
Reclassification adjustment-accumulated translation adjustment- discontinued operations		17,617		17,713
Change in unrealized gains on available-for-sale securities, net of tax	65,762	934	67,441	1,537
Minimum pension liability adjustments	87	(213)	260	1,382
Effect of income taxes			172	
Other comprehensive income	65,293	19,038	68,219	21,959
Comprehensive loss	$ (6,133)	$(30,092)	$(105,939)	$(720,568)

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

	June 30, 2004	September 30, 2003
Foreign currency translation adjustments	$ (2,677)	$ (3,023)
Unrealized gains on available-for-sale securities, net of tax	69,520	1,907
Minimum pension liability adjustments	(8,120)	(8,380)
Accumulated other comprehensive income (loss)	$58,723	$ (9,496)

7. Special Charges

Special charges consist of the following (in thousands):

	Three months ended June 30,		Nine months ended June 30,	
	2004	2003	2004	2003
Asset impairments	$2,508	$5,611	$ 4,534	$ 8,092
Restructuring charges	3,627		4,075	1,904
Integration charges	1,565		4,168	
Other	594	915	1,636	3,589
	$8,294	$6,526	$14,413	$13,585

Table of Contents

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

Asset Impairments

During the first nine months of 2003, the Company recorded asset impairment charges of $8.1 million, related to leasehold improvements associated with properties no longer occupied by the Company and other assets that management determined to abandon or scrap.

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

Restructuring Charges

In fiscal 2002 and continuing into fiscal 2003, the Company implemented a number of cost reduction initiatives to improve its operating cost structure. The cost reduction initiatives included workforce reductions, temporary shutdowns of the Company s manufacturing facilities, significant reductions in capital spending, the closure or consolidation of certain facilities and salary reductions for the senior management team until the Company returned to profitability. In the second and third quarters of fiscal 2004 in connection with the Merger, the Company implemented further workforce reductions and facility consolidations. The Company continuously evaluates the business in light of current market and competitive conditions to ensure that operating expenses are in line with expectations of revenue levels. As a result, future periods may require further actions to reduce operating expenses.

The costs and expenses associated with all the restructuring activities are included in special charges in the accompanying consolidated condensed statements of operations.

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

As part of the 2002 Corporate and Manufacturing Restructuring Plan, during the first quarter of fiscal 2003, the Company initiated a further workforce reduction affecting 58 employees and recorded additional charges of $1.9 million based upon estimates of the cost of severance benefits for the affected employees. During the third quarter of fiscal 2003, the Company revised its estimate of liabilities for severance benefits and facility costs due to unfavorable sublease experience to date, and charged an additional $1.5 million to restructuring expense. In the fourth quarter of 2003, the Company reversed $1.1 million of the estimated cost to settle the remaining commitment under a license obligation after its favorable resolution, and increased the estimate of remaining facility costs due to unfavorable sublease experience.

Activity and liability balances related to the 2002 Corporate and Manufacturing Restructuring Plan through June 30, 2004 were as follows (in thousands):

	Workforce reductions	Facility and other	Total
Charged to costs and expenses	$ 2,437	$ 12,519	$ 14,956
Cash payments	(1,664)	(431)	(2,095)
Restructuring balance, September 30, 2002	773	12,088	12,861
Charged to costs and expenses	2,898	888	3,786
Expense reversal		(1,100)	(1,100)
Cash payments	(3,173)	(3,930)	(7,103)
Restructuring balance, September 30, 2003	498	7,946	8,444
Cash payments	(447)	(3,114)	(3,561)
Restructuring balance, June 30, 2004	$ 51	$ 4,832	$ 4,883

Table of Contents

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

2003 Corporate Restructuring Plan In the fourth quarter of fiscal 2003, the Company initiated another workforce reduction, closed a design center and consolidated some facilities. The Company involuntarily terminated approximately 35 employees in the sales and administration areas and recorded charges aggregating $1.2 million based upon estimates of the cost of severance benefits for the affected employees. The Company also recorded restructuring costs of $2.8 million relating to the consolidation of certain facilities under non-cancelable leases which were vacated. In the first quarter of fiscal 2004, as a continuation of the 2003 Corporate Restructuring Plan, the Company vacated an additional facility and involuntarily terminated additional employees which resulted in an additional $0.4 million in restructuring expense.

Activity and liability balances related to the 2003 Corporate Restructuring Plan through June 30, 2004 were as follows (in thousands):

	Workforce reductions	Facility and other	Total
Charged to costs and expenses	$ 1,181	$2,830	$ 4,011
Cash payments	(364)		(364)
Restructuring balance, September 30, 2003	817	2,830	3,647
Charged to costs and expenses	350	98	448
Cash payments	(1,084)	(755)	(1,839)
Restructuring balance, June 30, 2004	$ 83	$2,173	$ 2,256

2004 Merger Restructuring and Reorganization Plans In connection with the Merger, in order to achieve operational efficiencies, the Company approved a plan of workforce reductions and facilities consolidation actions. These actions commenced in the quarter ended June 30, 2004 and are expected to continue through the December 2004 quarter. The Company will charge such amounts to restructuring expense in the period when the required actions are taken. As the restructuring progresses, approximately 200 employees of the Company, including approximately 50 employees of Conexant, Inc. in the 2004 Reorganization Plan described below, will be impacted by the actions. Through June 30, 2004, approximately 150 employees, including approximately 25 employees of Conexant, Inc., have been impacted by the actions. The Company involuntarily terminated approximately 125 employees in the sales and administration, and information technology areas and recorded charges aggregating $1.9 million based upon estimates of the cost of severance benefits for the affected employees. The Company also recorded restructuring costs of $1.8 million relating to the consolidation of certain facilities under non-cancelable leases which were vacated.

Activity and liability balances related to the 2004 Merger Restructuring Plan through June 30, 2004 were as follows (in thousands):

	Workforce reductions	Facility and other	Total
Charged to costs and expenses	$1,877	$1,750	$3,627
Cash payments	(733)	(86)	(819)
Restructuring balance, June 30, 2004	$1,144	$1,664	$2,808

In connection with the Merger, the Company also began to formulate the 2004 Reorganization Plan, which consisted primarily of workforce reductions to eliminate redundant positions and consolidation of the worldwide facilities of Conexant, Inc. In accordance with EITF 95-3 and SFAS No. 141,