

CONEXANT SYSTEMS INC

Form 10-Q

May 13, 2002

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**FORM 10-Q**

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

**For the  
quarterly  
period ended  
March 31,  
2002\* OR  
TRANSITION  
REPORT  
PURSUANT  
TO SECTION  
13 OR 15(d)  
OF THE  
SECURITIES  
EXCHANGE  
ACT OF 1934**

Commission file number: 000-24923

**CONEXANT SYSTEMS, INC.**

(Exact name of registrant as specified in its charter)

**Delaware**  
(State of incorporation)

**25-1799439**  
(I.R.S. Employer Identification No.)

**4311 Jamboree Road**  
**Newport Beach, California 92660-3095**  
(Address of principal executive offices) (Zip code)

**(949) 483-4600**  
(Registrant's telephone number, including area code)

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

Yes    No

Number of shares of registrant's common stock outstanding as of May 3, 2002 was 258,478,845.

\* For presentation purposes of this Form 10-Q, references made to the March 31, 2002 period relate to the actual fiscal second quarter ended March 29, 2002.

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**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 successful integration of acquisitions; the availability and extent of utilization of manufacturing capacity and raw materials; pricing pressures and other competitive factors; changes in our product mix; fluctuations in manufacturing yields; product obsolescence; our ability to develop and implement new technologies and to obtain protection of the related intellectual property; the successful implementation of our strategic manufacturing realignment, expense reduction and restructuring initiatives; the successful separation of our broadband access and Mindspeed Technologies' businesses; the successful spin-off and merger of our wireless communications business with Alpha Industries, Inc.; our labor relations and those of our customers and suppliers; our ability to attract and retain qualified personnel; the safety and security of our employees and of our facilities; and the uncertainties of litigation, 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.

Mindspeed Technologies is a trademark of Conexant Systems, Inc. Other brands, names and trademarks contained in this Quarterly Report are the property of their respective owners.

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

	<u>March 31,</u>	<u>September</u>
	<u>2002</u>	<u>30,</u>
		<u>2001</u>
<b>ASSETS</b>		
<b>Current assets:</b>		
Cash and cash equivalents	\$151,790	\$182,260
Short-term investments	108,276	156,660
Refundable deposit	150,000	
Receivables, net of allowance for doubtful accounts of \$14,880 and \$18,206 at March 31, 2002 and September 30, 2001, respectively	107,811	133,685
Inventories	99,423	122,397
Deferred income taxes	68,368	75,710
Other current assets	57,426	54,639
<hr/>		
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Total current assets	743,094	725,351
Property, plant and equipment, net	298,737	387,433
Goodwill and intangible assets, net	1,072,231	1,251,253
Deferred income taxes	194,289	183,444
Other assets	149,549	267,999
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Total assets  
\$2,457,900 \$2,815,480

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**LIABILITIES AND  
SHAREHOLDERS EQUITY**

**Current liabilities:**

Accounts payable  
\$121,709 \$98,141  
Deferred revenue  
17,042 27,149  
Accrued compensation and benefits  
59,750 50,407  
Other current liabilities  
89,350 107,300

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Total current liabilities  
287,851 282,997  
Convertible subordinated notes  
709,849 709,849  
Other long-term liabilities  
49,793 49,458

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Total liabilities  
1,047,493 1,042,304

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Commitments and contingencies

**Shareholders equity:**

Preferred and junior preferred stock

Common stock, \$1.00 par value:  
1,000,000 shares authorized;  
257,998 and 253,900 shares issued  
at March 31, 2002 and  
September 30, 2001, respectively

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257,998	253,900
Additional paid-in capital	
3,156,230	3,113,205
Accumulated deficit	
(1,971,401)	(1,566,209)
Accumulated other comprehensive loss	
(27,226)	(17,204)
Treasury stock, at cost: 41 shares at September 30, 2001	
(1,807)	
Unearned compensation	
(5,194)	(8,709)

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Total shareholders' equity	
1,410,407	1,773,176

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Total liabilities and shareholders' equity	
\$2,457,900	\$2,815,480

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See accompanying notes to consolidated condensed financial statements.

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

	Three months ended March 31,		Six months ended March 31,	
	2002	2001	2002	2001
Net revenues	\$241,031	\$251,003	\$470,550	\$661,364
Cost of goods sold				
153,465 334,168 319,468 630,771				
<hr/>				
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<hr/>				
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Gross margin				
87,566 (83,165) 151,082 30,593				
Operating expenses:				
Research and development				
114,889 128,879 226,483 247,417				
Selling, general and administrative				
53,974 89,741 109,662 170,117				
Amortization of intangible assets				
90,095 84,040 179,702 166,344				
Special charges				
21,384 11,848 22,384 19,775				
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<hr/>				
<hr/>				
Total operating expenses				
280,342 314,508 538,231 603,653				
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Operating loss  
(192,776) (397,673) (387,149) (573,060)  
Debt conversion costs  
(42,584)  
Other expense, net  
(6,802) (1,021) (15,919) (5,377)

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Loss before income taxes  
(199,578) (398,694) (403,068) (621,021)  
Provision (benefit) for income taxes  
1,124 (136,683) 2,124 (152,150)

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Loss before extraordinary item  
(200,702) (262,011) (405,192) (468,871)  
Extraordinary gain on extinguishment of debt, net of  
income taxes of \$4,426  
7,284

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Net loss  
\$(200,702) \$(262,011) \$(405,192) \$(461,587)

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Loss per share, basic and diluted:

Loss before extraordinary item  
\$(0.78) \$(1.08) \$(1.59) \$(1.96)  
Extraordinary item  
0.04

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Net loss  
\$(0.78) \$(1.08) \$(1.59) \$(1.92)

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Number of shares used in per share computation  
256,135 243,515 255,249 239,813

See accompanying notes to consolidated condensed financial statements.

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

	<b>Six months ended March 31,</b>	
	<b>2002</b>	<b>2001</b>
<b>Cash flows from operating activities:</b>		
Net loss		
	\$(405,192)	\$(461,587)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation		
	51,615	98,250
Amortization of intangible assets		
	179,702	166,344
Asset impairments		
	25,261	
Provision for losses on accounts receivable		
	(1,073)	12,913
Inventory provisions		
	11,800	206,050
Deferred income taxes		
	(2,252)	(149,482)
Stock compensation		
	3,698	6,791
Debt conversion costs		
	42,584	
Extraordinary gain extinguishment of debt		
	(11,710)	
Other non-cash items, net		
	(1,624)	7,951
Changes in assets and liabilities:		
Receivables		
	26,947	160,602
Inventories		
	3,744	(118,705)
Accounts payable		
	22,835	(103,876)
Deferred revenue		
	(10,107)	(8,229)
Accrued expenses and other current liabilities		
	131	(15,937)
Other		
	(10,936)	(10,456)

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Net cash used in operating activities  
(105,451) (178,497)

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**Cash flows from investing  
activities:**

Net sales (purchases) of marketable  
securities  
49,260 (253,658)  
Capital expenditures  
(19,477) (118,833)  
Proceeds from sale of assets  
41,696  
Investments in and advances to  
businesses  
(4,060) (89,090)  
Acquisitions of businesses, net of  
cash acquired  
(2,673) (12,512)

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Net cash provided by (used in)  
investing activities  
64,746 (474,093)

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**Cash flows from financing  
activities:**

Proceeds from exercise of stock  
options  
10,235 10,618  
Payment of debt conversion costs  
(42,584)  
Repurchase of convertible  
subordinated notes  
(22,400)

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Net cash provided by (used in)  
financing activities  
10,235 (54,366)

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Net decrease in cash and cash  
equivalents  
(30,470) (706,956)  
Cash and cash equivalents at  
beginning of period  
182,260 831,100

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Cash and cash equivalents at end of  
period  
\$151,790 \$124,144

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See accompanying notes to consolidated condensed financial statements.



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

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

Conexant Systems, Inc. (Conexant or the Company) is a worldwide leader in semiconductor system solutions for communications applications. The Company's expertise in mixed-signal processing allows it to deliver integrated systems and semiconductor products which facilitate communications worldwide through wireline voice and data communications networks, cellular telephony systems and emerging cable, satellite and fixed wireless broadband communications networks. The Company operates in two business segments: the Personal Networking business and Mindspeed Technologies, the Company's Internet infrastructure business.

On December 16, 2001, the Company entered into agreements with Washington Sub, Inc. (Washington), currently a wholly-owned subsidiary of Conexant, and Alpha Industries, Inc. (Alpha), a provider of radio frequency (RF) and microwave integrated circuit products and solutions primarily for wireless communications. Under the agreements, the Company will contribute to Washington its wireless communications business, including its Newbury Park, California gallium arsenide wafer fabrication facility, but excluding certain assets and liabilities, and will distribute all the outstanding shares of Washington to Conexant shareholders (the Wireless Spin-off). Immediately thereafter, Washington will merge with and into Alpha, with Alpha as the surviving corporation (the Merger). Completion of the Wireless Spin-off and the Merger are subject to, among other things, regulatory approvals, a ruling by the Internal Revenue Service (IRS) that the Wireless Spin-off qualifies as tax-free and approval of the Merger by Alpha's stockholders. Upon completion of the Merger, Alpha will purchase Conexant's semiconductor assembly and test facility, located in Mexicali, Mexico, and certain related assets, for \$150 million. The waiting period for the Hart-Scott-Rodino Antitrust Improvements Act of 1976 terminated on January 29, 2002. There can be no assurance that the other regulatory approvals, the IRS ruling or the approval of the Merger by Alpha's stockholders will be obtained, or that the Wireless Spin-off and the Merger will be successfully completed.

In September 2000, the Company announced a plan for the separation of its broadband access and Mindspeed Technologies businesses. Although current business conditions have delayed the separation, the Company remains committed to completing the separation as soon as business and market conditions permit. The separation is subject to receipt of a ruling from the IRS that the related spin-off will qualify as a tax-free distribution and may be subject to approval of the Company's shareholders. An IRS ruling has been received and although it is generally binding on the IRS, its continuing applicability will depend on the form of the separation transaction and the extent of intervening events between the date of the ruling and the separation. There can be no assurance that the separation will be successfully completed.

In the opinion of management, the accompanying consolidated condensed financial statements contain all adjustments, consisting of adjustments of a normal recurring nature, as well as the inventory write-downs, special charges, debt conversion costs and extraordinary gain on extinguishment of debt, necessary to present fairly the Company's financial position, results of operations and cash flows. The results of operations for interim periods are not necessarily indicative of the results that may be expected for a full year. These statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended September 30, 2001.

**Fiscal Periods** For presentation purposes, references made to the periods ended March 31, 2002 and 2001 relate to the actual fiscal 2002 second quarter ended March 29, 2002 and the actual fiscal 2001 second quarter ended March 30, 2001, respectively.

**Supplemental Cash Flow Information** Cash paid for interest was \$14.3 million and \$20.7 million for the six months ended March 31, 2002 and 2001, respectively. Net income tax payments (refunds) for the six months ended March 31, 2002 and 2001 were \$(6.5) million and \$2.5 million, respectively.

**Recent Accounting Standards** In June 2001, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 141, Business Combinations and SFAS No. 142, Goodwill and Other Intangible Assets. SFAS 141 requires that all business combinations be accounted for using the purchase method and provides new criteria for recording intangible assets separately from goodwill. Existing goodwill and

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

intangible assets will be evaluated against these new criteria, which may result in certain intangible assets being subsumed into goodwill. SFAS 142 addresses financial accounting and reporting for acquired goodwill and other intangible assets. Goodwill and intangible assets that have indefinite useful lives will not be amortized into results of operations, but instead will be evaluated at least annually for impairment and written down when the recorded value exceeds the estimated fair value. The Company will adopt the provisions of each statement which apply to goodwill and intangible assets acquired prior to June 30, 2001 as of the beginning of fiscal 2003. However, SFAS 142 is immediately applicable to any goodwill and intangible assets the Company may acquire after June 30, 2001. Upon adoption, the Company will cease amortizing goodwill against its results of operations, reducing annual amortization expense by approximately \$285 million. The Company is evaluating the full impact of adopting the new standards. In addition, impairment reviews may result in charges against earnings to write down the value of goodwill.

In August 2001, the FASB issued SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, which supersedes previous guidance on financial accounting and reporting for the impairment or disposal of long-lived assets and for segments of a business to be disposed of. Adoption of SFAS 144 is required no later than the beginning of fiscal 2003. Management does not expect the adoption of SFAS 144 to have a significant impact on the Company's financial position or results of operations. However, future impairment reviews may result in charges against earnings to write down the value of long-lived assets.

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

**2. Supplemental Financial Statement Data**

The refundable deposit, currently held by a wafer supplier under an agreement for foundry capacity, is classified as a current asset as of March 31, 2002 because the Company expects the supplier to repay this deposit during fiscal 2002. The refundable deposit was included in other assets at September 30, 2001.

Inventories consist of the following (in thousands):

	<b>March 31, 2002</b>	<b>September 30, 2001</b>
Raw materials	\$7,678	\$ 10,727
Work-in-process		
65,937		100,012
Finished goods		
25,808	11,658	
_____		
_____		
	\$99,423	\$122,397
_____		
_____		

**3. Contingent Liabilities**

Claims have been asserted against the Company 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 resolution of such claims through

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arbitration or litigation. In connection with its spin-off from Rockwell International Corporation, now named Rockwell Automation, Inc. (Rockwell), the Company assumed responsibility for all contingent liabilities and current and future litigation (including environmental and intellectual property proceedings) against Rockwell or its subsidiaries in respect of the operations of the semiconductor systems business of Rockwell.

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.

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

**4. Comprehensive Income (Loss)**

Comprehensive income (loss) for the three months and six months ended March 31, 2002 and 2001 is as follows (in thousands):

	Three months ended March 31,		Six months ended March 31,	
	2002	2001	2002	2001
Net loss	\$(200,702)	\$(262,011)	\$(405,192)	\$(461,587)
Other comprehensive loss:				
Foreign currency translation adjustments				
(6,001) (8,097) (8,450) (16,369)				
Change in unrealized gains on available-for-sale securities				
(1,731) (1,998) (2,866) (52,566)				
Change in unrealized gains on forward exchange contracts				
153 220 43 291				
Effect of income taxes				
754 756 1,251 20,168				
Other comprehensive loss				
(6,825) (9,119) (10,022) (48,476)				
Comprehensive loss				
\$(207,527) \$(271,130) \$(415,214) \$(510,063)				

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

	<u>March 31, 2002</u>	<u>September 30, 2001</u>
Unrealized gains (losses) on available-for-sale securities, net of tax	\$(24)	\$1,591
Unrealized losses on forward exchange contracts (43)		
Foreign currency translation adjustments (27,202) (18,752)		
<hr/>		
<hr/>		
Accumulated other comprehensive loss		
\$(27,226) \$(17,204)		

**5. Special Charges**

During the first six months of fiscal 2002, the Company recorded restructuring charges aggregating \$4.7 million principally relating to additional workforce reductions and facility consolidation costs. The charges were based on the estimated cost of severance benefits for approximately 300 affected employees and lease cancellation and related costs. The actions reduced the Company's workforce in both the Personal Networking and Mindspeed Technologies segments, including approximately 100 affected employees at our former El Paso, Texas board-level sub-assembly business. Activity and liability balances related to restructuring actions through March 31, 2002 are as follows (in thousands):

	<u>Workforce reductions</u>	<u>Facility and other</u>	<u>Total</u>
Restructuring balance, September 30, 2001	\$6,095	\$5,361	\$11,456
Charged to costs and expenses			
4,310 343 4,653			
Cash payments			
(6,190) (1,465) (7,655)			
Non-cash costs			
(322) (287) (609)			

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Restructuring balance, March 31, 2002  
\$3,893 \$3,952 \$7,845

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A majority of the amounts accrued for these actions are expected to be paid within one year. Cash payments to complete the restructuring actions will be funded from available cash reserves and funds from operations, and are not expected to significantly impact the Company's liquidity.

During the first six months of fiscal 2002, the Company recorded an impairment charge of \$13.0 million in the Personal Networking segment to write down the value of the goodwill related to its digital imaging business. The impairment resulted from the Company's decision to exit the digital imaging business and the adoption of a plan to dispose of the related assets. Management evaluated the recoverability of the assets of the digital imaging business to determine if their value was impaired. The amount of the impairment charge was determined by comparing the assets estimated fair values, less costs to sell, to their carrying values. Management believes the assumptions used in estimating the fair values are reasonable and approximate the amounts that will be realized upon the ultimate sale or disposition of the related assets. The write-down established a new cost basis for the impaired assets. The Company also recorded impairment charges totaling \$4.6 million associated with certain technology assets included in the Mindspeed Technologies segment that management had determined to abandon or sell.

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

Special charges for the first six months of fiscal 2001 consisted of \$12.2 million of costs related to the previously announced separation of the Mindspeed Technologies business from Conexant and \$7.6 million for restructuring charges, principally related to workforce reductions.

**6. Sales of Assets**

In March 2002, the Company and The Carlyle Group formed a new specialty foundry company called Jazz Semiconductor, in which Conexant owns a 45% equity interest and The Carlyle Group owns the remaining 55%. In the transaction, Conexant contributed its Newport Beach, California wafer fabrication operations and certain intellectual property to Jazz Semiconductor. In connection with this transaction, the Company received \$19.3 million in cash and the 45% equity interest in Jazz Semiconductor, having an estimated fair value of \$42.5 million. In addition to contributing its Newport Beach wafer fabrication operations (with a carrying value of approximately \$43.2 million) and certain related assets and liabilities, the Company also issued to Jazz Semiconductor a warrant to purchase 2.9 million shares of Conexant common stock at a price of \$13.05 per share (the fair market value on the date of grant of the warrant). The warrant had a fair value of \$14.2 million, determined by an independent valuation specialist.

This transaction resulted in a \$2.6 million gain, which represents the difference between the Company's carrying value and the fair value of the net assets deemed to have been sold by the Company to Jazz Semiconductor. The Company will account for its investment in Jazz Semiconductor under the equity method of accounting.

The Company expects to purchase a substantial portion of its requirements for silicon-based semiconductor products from Jazz Semiconductor. During the first two years of the long-term supply arrangement with Jazz Semiconductor, the Company's cost of wafers will be an amount which approximates its historical cost. Thereafter, the cost of wafers will be based on market prices. Additionally, the Company is obligated to purchase certain minimum annual volumes of wafers. 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 Semiconductor.

In December 2001, the Company sold two buildings for net proceeds of \$19.3 million. A \$2.1 million gain arising from the sale of one building was recognized upon completion of the transaction. The Company will continue to occupy the second building under a 15-year lease. Consequently, the \$7.8 million gain arising from the sale of the leased-back building has been deferred and will be recognized ratably over the lease term. The lease requires the Company to make minimum lease payments aggregating \$1.4 million annually (subject to certain adjustments).

**7. Segment Information**

The Company operates and tracks its results in two reportable segments Personal Networking and Mindspeed Technologies. The Personal Networking segment designs, develops and sells semiconductor system solutions for two general personal communications applications markets wireless communications and broadband access. For segment reporting purposes, these product groups have been aggregated because of their common characteristics and their reliance on shared operating functions. Mindspeed Technologies designs, develops and sells semiconductor networking solutions that facilitate the aggregation, transmission and switching of data, video and voice from the edge of the Internet to linked metropolitan area networks and long-haul networks.

The Company evaluates segment performance based on segment operating income (loss) excluding amortization of intangible assets, special charges and stock compensation costs. Special charges excluded from segment operating income (loss) consist of restructuring charges, asset impairments and separation costs incurred in connection with the proposed separation of the broadband access and Mindspeed Technologies businesses.

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

The tables below present information about reportable segments (in thousands):

	Three months ended March 31,		Six months ended March 31,	
	2002	2001	2002	2001
Net revenues:				
Personal Networking				
\$222,013 \$169,718 \$437,354 \$414,174				
Mindspeed Technologies				
19,018 81,285 33,196 247,190				
Segment totals				
\$241,031 \$251,003 \$470,550 \$661,364				
Operating loss:				
Personal Networking				
\$(30,241) \$(213,090) \$(76,052) \$(319,442)				
Mindspeed Technologies				
(50,604) (86,476) (106,232) (62,793)				



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Segment totals  
 (80,845) (299,566) (182,284) (382,235)  
 Amortization of intangible assets  
 90,095 84,040 179,702 166,344  
 Special charges  
 21,384 11,848 22,384 19,775  
 Stock compensation  
 452 2,219 2,779 4,706

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Operating loss  
 \$(192,776) \$(397,673) \$(387,149) \$(573,060)

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

	Three months ended March 31,		Six months ended March 31,	
	2002	2001	2002	2001
Americas	\$36,441	\$87,075	\$65,318	\$246,041
Europe, Middle East and Africa	31,222	32,620	51,172	93,437
Japan	12,444	10,956	25,756	37,288
Asia-Pacific	160,924	120,352	328,304	284,598

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\$241,031 \$251,003 \$470,550 \$661,364

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For the six months ended March 31, 2002, one customer accounted for 20% of net revenues; no customer accounted for 10% or more of the Company's net revenues for the six months ended March 31, 2001.

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

This information should be read in conjunction with our unaudited consolidated condensed financial statements and the notes thereto included in this Quarterly Report, and our audited consolidated financial statements and notes thereto and Management's Discussion and Analysis of Financial Condition and Results of Operations contained in our Annual Report on Form 10-K for the fiscal year ended September 30, 2001.

**Overview**

We are a worldwide leader in semiconductor system solutions for communications applications. Our expertise in mixed-signal processing allows us to deliver integrated systems and semiconductor products which facilitate communications worldwide through wireline voice and data communications networks, cellular telephony systems and emerging cable, satellite and fixed wireless broadband communications networks. We operate in two business segments: the Personal Networking business and Mindspeed Technologies, our Internet infrastructure business.

Our Personal Networking business designs, develops and sells semiconductor system solutions for wireless communications and broadband access applications. Our wireless communications products are comprised of components, subsystems, and system-level semiconductor solutions for wireless voice and data applications supporting the world's most widely-adopted wireless standards, including code division multiple access (CDMA), time division multiple access (TDMA) and global system for mobile communications (GSM). Our wireless communications products include power amplifier modules, radio frequency components and subsystems, and complete cellular systems for digital cellular handsets and base stations as well as advanced mobile terminals that support next-generation multimedia and high-speed web browsing. Our broadband access products include semiconductor solutions that connect personal access products such as set-top boxes, residential gateways, personal computers (PCs) and game consoles to voice, video and data processing services over broadband connections and our foundation analog communication products such as PC data and fax modems.

Mindspeed Technologies designs, develops and sells semiconductor networking solutions that facilitate the aggregation, transmission and switching of data, video and voice from the edge of the Internet to linked metropolitan area networks and long-haul networks. Mindspeed Technologies' products, ranging from physical-layer devices to higher layer network processors, are sold to infrastructure original equipment manufacturers (OEMs) and can be classified into two general categories: wide area network (WAN) access products and WAN transport products. WAN access products include multi-service access gateway solutions, including voice-over-Internet protocol, and a broad family of multi-megabit digital subscriber line (DSL) products that are used in a variety of network access platforms such as remote access concentrators, voice gateways, digital loop carriers, DSL access multiplexers and integrated access devices. WAN transport products include T/E carrier, asynchronous transfer mode (ATM), and synchronous optical networking (SONET)/synchronous digital hierarchy (SDH) transceivers, switch products, network processors and software subsystems. Our customers use these solutions in a variety of network equipment, including high-speed routers, ATM switches, optical switches, add-drop multiplexers, digital cross-connect systems and dense wave division multiplexer equipment.

We market and sell our semiconductor products and system solutions directly to leading OEMs of communication electronics products and third-party electronic manufacturing service providers, and indirectly through electronic components distributors. Sales to distributors accounted for approximately 15% of net revenues in the first six months of fiscal 2002. One customer accounted for 20% of our net revenues in the first six months of fiscal 2002; no other customer accounted for 10% or more of our net revenues for the period. Our top 20 customers accounted for 72% of net revenues for the first six months of fiscal 2002. Revenues derived from customers located in the Americas, Europe, Japan and the Asia-Pacific region were 14%, 11%, 5% and 70%, respectively, of our net revenues for the first six months of fiscal 2002. We believe a substantial portion of the products we sell to OEMs and third-party manufacturing service providers in the Asia-Pacific region are ultimately shipped to end-markets in the Americas and Europe.

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### ***Newport Foundry Joint Venture***

In March 2002, we and The Carlyle Group formed a new specialty foundry company called Jazz Semiconductor, in which we own a 45% equity interest. We contributed our Newport Beach, California wafer fabrication operations, certain intellectual property, and related assets and liabilities to Jazz Semiconductor. We also issued to Jazz Semiconductor a warrant to purchase 2.9 million shares of Conexant common stock (at a price of \$13.05 per share). In connection with this transaction, we received \$19.3 million in cash and the 45% equity interest in the joint venture, having an estimated fair value of \$42.5 million. We recognized a \$2.6 million gain on the transaction.

We expect to purchase a substantial portion of our requirements for silicon-based semiconductor products from Jazz Semiconductor. We entered into a long-term supply arrangement with Jazz Semiconductor under which the joint venture will provide capacity to meet a portion of our requirements for CMOS and specialty-process wafer fabrication services and we agreed to purchase certain minimum annual volumes of wafers during the first three years of the supply agreement.

### ***Spin-off and Merger of Wireless Communications Business***

On December 16, 2001, we entered into agreements with Washington Sub, Inc. (Washington), currently a wholly-owned subsidiary of ours, and Alpha Industries, Inc. (Alpha), a provider of radio frequency (RF) and microwave integrated circuit products and solutions principally for wireless communications. Under the agreements, we will contribute to Washington our wireless communications business, including our Newbury Park, California gallium arsenide wafer fabrication facility, but excluding certain assets and liabilities, and will distribute all the outstanding shares of Washington to our shareholders (the Wireless Spin-off). Immediately thereafter, Washington will merge with and into Alpha, with Alpha as the surviving corporation (the Merger). Completion of the Wireless Spin-off and the Merger are subject to, among other things, regulatory approvals, a ruling by the Internal Revenue Service (IRS) that the Wireless Spin-off qualifies as tax-free and approval of the Merger by Alpha's stockholders. Upon completion of the Merger, Alpha will purchase our semiconductor assembly and test facility, located in Mexicali, Mexico, and certain related assets, for \$150 million. The waiting period for the Hart-Scott-Rodino Antitrust Improvements Act of 1976 terminated on January 29, 2002. We cannot assure you that the other regulatory approvals, the IRS ruling or the approval of the Merger by Alpha's stockholders will be obtained, or that we will successfully complete the Wireless Spin-off and the Merger.

### ***Separation of Mindspeed Technologies Business from Conexant***

In September 2000, we announced a plan for the separation of our broadband access and Mindspeed Technologies businesses. Although current business conditions have delayed the separation, we remain committed to completing the separation as soon as business and market conditions permit. The separation is subject to receipt of a ruling from the IRS that the related spin-off will qualify as a tax-free distribution and may be subject to the approval of our shareholders. An IRS ruling has been received and although it is generally binding on the IRS, its continuing applicability will depend on the form of the separation transaction and the extent of intervening events between the date of the ruling and the separation. We cannot assure you that we will successfully complete the separation.

## **Results of Operations**

We like many of our customers and competitors were adversely impacted throughout all of fiscal 2001 by a broad slowdown affecting the technology sector, including most of the communications electronics end-markets which our products address. Wireless communications net revenues for fiscal 2001 reflect a deterioration in the digital cellular handset market, as compared with fiscal 2000, which resulted from excess channel inventories due to a slowdown in demand for cellular phones and a slower transition to next-generation phones. In addition, sales of our broadband access products were affected by slower than anticipated deployment of broadband services by system providers. Moreover, weak consumer demand for PCs and related peripheral devices and satellite set-top boxes led to lower sales of our products for these applications as compared to prior year levels. Net revenues in our Mindspeed Technologies business were also significantly affected by slowing investment in communications network capacity expansion by Internet service providers (ISPs), competitive local exchange carriers (CLECs) and incumbent local exchange and inter-exchange carriers. In most cases, the effect of weakened end-customer demand was compounded by higher than normal levels of equipment and component inventories among our OEM, subcontractor and distributor customers.

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During the first six months of fiscal 2002, our Personal Networking segment saw strong demand for our wireless communications product portfolio and improved demand in a number of the markets addressed by our broadband access products. Although a comparison of our consolidated quarterly results of operations on a year-over-year basis will remain unfavorable in the near term, the second quarter of fiscal 2002 represents the third consecutive quarter of sequential revenue growth in our wireless communications and broadband access businesses. Also during the second quarter of fiscal 2002, our Mindspeed Technologies segment achieved sequential revenue growth of 34% over the preceding quarter. For the third quarter of fiscal 2002, we expect sequential revenue growth of three to five percent from the immediately preceding quarter. We anticipate that our gross margin will continue to improve to approximately 38 percent and we expect a sequential improvement of 15% in the level of our pro forma operating loss in the third quarter of fiscal 2002.

**Net Revenues**

The following table summarizes our net revenues:

(in millions)	Three months ended			Change from Dec. 2001 quarter	Change from Mar. 2001 quarter
	March 31, 2002	December 31, 2001	March 31, 2001		
<b>Net revenues:</b>					
Personal Networking:					
Wireless communications	\$95.1	\$92.3	\$56.3	3%	69%
Broadband access	126.9	123.0	113.4	3%	12%
<hr/>					
<hr/>					
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Total Personal Networking	222.0	215.3	169.7	3%	31%
Mindspeed Technologies	19.0	14.2	81.3	34%	(77)%
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<hr/>					
	\$241.0	\$229.5	\$251.0	5%	(4)%
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**As a percentage of net revenues:**

Personal Networking:

Wireless communications

39% 40% 23%

Broadband access

53% 54% 45%

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Total Personal Networking

92% 94% 68%

Mindspeed Technologies

8% 6% 32%

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100% 100% 100%

**Six months ended March 31,**

2002

2001

Change

**Net revenues:**

Personal Networking:

Wireless communications

\$187.5 \$140.2 34%

Broadband access

249.9 274.0 (9)%

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Total Personal Networking

437.4 414.2 6%

Mindspeed Technologies

33.2 247.2 (87)%

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\$470.6 \$661.4 (29)%

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**As a percentage of net revenues:**

Personal Networking:

Wireless communications

40% 21%

Broadband access

53% 42%

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Total Personal Networking

93% 63%

Mindspeed Technologies

7% 37%

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100% 100%

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***Wireless Communications***

Our wireless communications product revenues for the first six months of fiscal 2002, up 34% from the comparable period of fiscal 2001, reflect increased unit shipments of our global system for mobile communications (GSM) cellular system solutions. We also experienced increased demand for power amplifier modules for both CDMA and GSM applications. These revenue increases were partially offset by lower sales

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volume of 900MHz digital cordless telephone chipsets and by the impact of the sale of our global positioning system (GPS) business to SiRF Technology, Inc. in the third quarter of fiscal 2001.

In our second quarter a period generally characterized by seasonally weak demand we continued to experience strong demand across our major wireless communications product lines. As a result, in the fiscal 2002 second quarter we achieved a 3% increase in wireless communications revenues compared with the immediately preceding



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quarter, driven by market share gains in power amplifiers, strength in radio frequency subsystems, and record unit shipments of complete GSM general packet radio service (GPRS) cellular system solutions.

**Broadband Access**

Our broadband access product revenues for the first six months of fiscal 2002 were 9% lower than the comparable period of fiscal 2001. The decline reflects relatively weaker end-market demand for personal access products such as set-top boxes, PCs, game consoles and fax machines compared with the same period in fiscal 2001. Consequently, our broadband access net revenues for the first six months of fiscal 2002 reflect lower unit shipments of our analog dial-up modems and our satellite set-top box tuners and demodulators. These declines were partially offset by higher sales of media processing products, including our broadcast video encoder/decoder and set-top box MPEG 2 solutions.

While revenue comparisons on a year-over-year basis remain unfavorable, our broadband access revenues for the fiscal 2002 second quarter increased 3% over the immediately preceding quarter the third consecutive quarter of sequential revenue growth driven by sustained demand for our PC data and fax modems, and increased demand for digital media gateway products, including asymmetric digital subscriber line (ADSL) and cable modems, as well as set-top box and home networking solutions.

**Mindspeed Technologies**

Since the second quarter of fiscal 2001, net revenues for Mindspeed Technologies have been impacted by the sharply lower demand for network equipment which has affected us, our customers and our competitors. ISPs and CLECs have dramatically reduced their investment in network capacity expansion as their business models failed to generate sufficient cash flow. Incumbent local exchange carriers and inter-exchange carriers have also reduced their capital spending. Demand has been further affected by higher-than-normal levels of equipment and component inventories among many OEM, subcontractor and distributor customers. As a result, Mindspeed Technologies net revenues for the first six months of fiscal 2002 compared with the comparable fiscal 2001 period reflect lower sales volume across the majority of our WAN access and WAN transport products, including multi-service access processors, multi-megabit DSL and optical networking physical media devices, and transceivers.

In the fiscal 2002 second quarter, net revenues for Mindspeed Technologies showed sequential revenue growth of 34% over the immediately preceding quarter. While revenue growth was strongest among our WAN transport product lines, we experienced revenue growth across each of our key access product families.

**Gross Margin**

(in millions)	Three months ended			Change	Change
	March 31, 2002	December 31, 2001	March 31, 2001	from Dec. 2001	from Mar. 2001
				Quarter	Quarter
Gross margin	\$87.6	\$ 63.5	\$(83.2)	38%	nm
Percent of net revenues	36%	28%	(33)%		

	Six months ended March 31,			Change
	2002	2001		
Gross margin	\$ 151.1	\$ 30.6		394%
Percent of net revenues	32%	5%		

nm = not meaningful

Cost of goods sold consists primarily of purchased materials, labor and overhead (including depreciation) associated with product manufacturing, royalty and other intellectual property costs, warranties and sustaining engineering expenses pertaining to products sold. During

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the first six months of fiscal 2002 our gross margin continued to be adversely affected by the impact of lower revenues (down 29% from the comparable period of fiscal 2001) on a base of relatively fixed manufacturing support costs, which was partially offset by lower depreciation expense as a result of the write-down of manufacturing assets in fiscal 2001. Gross margins for the second quarter and first six months of fiscal 2001 included inventory write-downs of approximately \$148.6 million and \$206.1 million, respectively.

When compared with the immediately preceding quarter, our gross margins for the second quarter of fiscal 2002 improved from 28% to 36% of net revenues, reflecting increased quarterly sales and higher utilization of our

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manufacturing capacity. Gross margins for the first six months of fiscal 2002 were adversely impacted by provisions for excess and obsolete inventories of \$11.8 million and additional warranty costs of \$14.0 million. The effect of these charges was partially offset by the sale of approximately \$32.8 million of inventories that we had written down to a zero cost basis during fiscal year 2001.

The inventory write-downs we recorded in the first six months of fiscal 2001 resulted from the sharply reduced end-customer demand for PCs, Internet infrastructure equipment and digital cellular handsets during that period. As a result of these market conditions, we experienced a significant number of order cancellations and a decline in the volume of new orders beginning in the fiscal 2001 first quarter, and becoming more pronounced in the second quarter. We assess the recoverability of inventories through an on-going review of inventory levels in relation to sales backlog and forecasts, product marketing plans and product life cycles. When the inventory on hand exceeds the foreseeable demand, we write down the value of those inventories which, at the time of our review, we expect to be unable to sell. The amount of the write-down is the excess of historical cost over estimated realizable value (generally zero). Once established, these write-downs are considered permanent adjustments to the cost basis of the excess inventory.

As of March 31, 2002, we continue to hold inventories with an original cost of approximately \$138.8 million which were previously written down to a zero cost basis. We currently intend to hold these remaining inventories and will sell these inventories if we experience renewed demand for these products. While there can be no assurance that we will be able to do so, if we are able to sell a portion of the inventories which are carried at zero cost basis, our gross margins will be favorably affected. To the extent that we do not experience renewed demand for the remaining inventories, they will be scrapped as they become obsolete.

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

We expect to purchase a substantial portion of our requirements for silicon-based semiconductor products from Jazz Semiconductor. During the first two years of the long-term supply arrangement with Jazz Semiconductor, our cost of wafers will be an amount which approximates our historical cost. Thereafter, our cost of wafers will be based on market prices. Additionally, we are obligated to purchase certain minimum annual volumes of wafers. In the event our actual wafer purchases are less than the required minimum volumes, we will be required to make additional payments to Jazz Semiconductor, which would adversely affect our gross margin.

**Research and Development**

(in millions)	Three months ended March 31,			Six months ended March 31,		
	2002	Change	2001	2002	Change	2001
Research and development	\$ 114.9	(11)%	\$ 128.9	\$ 226.5	(8)%	\$ 247.4
Percent of net revenues	48%	51%	48%	37%		

Our research and development (R&D) expenses consist principally of direct personnel costs, costs for pre-production evaluation and testing of new devices and design and test tool costs. Our R&D expenses also include the costs for advanced semiconductor process development, design automation and advanced package development for the benefit of each of our businesses. The decreases in R&D expenses for the second quarter and first six months of fiscal 2002 compared to the similar periods of fiscal 2001 primarily reflect lower headcount and personnel-related costs resulting from the expense reduction and restructuring actions initiated during fiscal 2001.

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

(in millions)	Three months ended March 31,			Six months ended March 31,		
	2002	Change	2001	2002	Change	2001
Selling, general and administrative	\$54.0	(40)%	\$89.7	\$109.7	(36)%	\$170.1
Percent of net revenues						
22% 36% 23% 26%						

Our selling, general and administrative (SG&A) expenses include personnel costs, sales representative commissions, advertising and other marketing costs. Our SG&A expenses also include costs of corporate functions including legal, accounting, treasury, human resources, real estate, information systems, customer service, sales, marketing, field application engineering and other services. The decreases in SG&A expenses for the second quarter and first six months of fiscal 2002 compared to the similar periods of fiscal 2001 primarily reflect lower headcount and personnel-related costs resulting from the expense reduction and restructuring actions initiated during fiscal 2001 and lower provisions for uncollectible accounts receivable.

**Amortization of Intangible Assets**

(in millions)	Three months ended March 31,			Six months ended March 31,		
	2002	Change	2001	2002	Change	2001
Amortization of intangible assets	\$90.1	7%	\$84.0	\$179.7	8%	\$166.3

The higher amortization expenses in the second quarter and first six months of fiscal 2002 primarily resulted from the additional consideration paid subsequent to March 2001 in connection with certain of our fiscal 2000 business acquisitions. The value of the additional consideration paid was added to the recorded amounts of goodwill, and is amortized over the remainder of the original estimated lives of the goodwill.

Under the recently issued Statement of Financial Accounting Standards No. 142, which we will adopt in the first quarter of fiscal 2003, we will cease amortizing goodwill against our results of operations, reducing annual amortization expense by approximately \$285 million. However, we will be required to evaluate goodwill at least annually for impairment, and to write down the value of goodwill with a charge against our results of operations when the recorded value of goodwill exceeds its estimated fair value.

**Special Charges**

During the first six months of fiscal 2002, we recorded restructuring charges aggregating \$4.7 million principally relating to additional workforce reductions and facility consolidation costs. The charges were based on the estimated cost of severance benefits for approximately 300 affected employees and lease cancellation and related costs. The actions reduced our workforce in both our Mindspeed Technologies and Personal Networking segments, including approximately 100 affected employees at our former El Paso, Texas board-level sub-assembly business. Activity and liability balances related to restructuring actions through March 31, 2002 are as follows (in thousands):

	Workforce reductions	Facility and other	Total
Restructuring balance, September 30, 2001	\$6,095	\$5,361	\$11,456
Charged to costs and expenses			
4,310 343 4,653			
Cash payments			
(6,190) (1,465) (7,655)			
Non-cash costs			
(322) (287) (609)			

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Restructuring balance, March 31, 2002  
\$3,893 \$3,952 \$7,845

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We expect to pay a majority of the amounts accrued for these actions within one year. Cash payments to complete the restructuring actions will be funded from available cash reserves and funds from operations, and are not expected to significantly impact our liquidity. We anticipate that these actions, when fully implemented, will result in a cost savings of approximately \$20 million annually.

During the first six months of fiscal 2002, we recorded an impairment charge of \$13.0 million to write down the value of the goodwill related to our digital imaging business. The impairment resulted from our decision to exit the digital imaging business and our adoption of a plan to dispose of the related assets. We evaluated the recoverability of the digital imaging assets to determine if the value of the assets was impaired. We determined the amount of the impairment charge by comparing the assets' estimated fair values, less costs to sell, to their carrying values. We

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believe the assumptions used in estimating the fair values are reasonable and approximate the amounts that will be realized upon the ultimate sale or disposition of the related assets. The write-down established a new cost basis for the impaired assets. We also recorded impairment charges aggregating \$4.6 million associated with certain technology assets in the Mindspeed Technologies segment that management determined to abandon or sell.

Special charges for the first six months of fiscal 2001 consisted of \$12.2 million of costs related to the previously announced separation of our Mindspeed Technologies business from Conexant and \$7.6 million for restructuring charges, principally related to workforce reductions.

**Debt Conversion Costs**

In the first quarter of fiscal 2001, approximately \$255.1 million principal amount of our 4-1/4% Convertible Subordinated Notes due 2006 were converted into approximately 11.0 million shares of our common stock, at a cost of \$42.6 million.

**Other Expense, Net**

(in millions)	Three months ended March 31,			Six months ended March 31,		
	2002	Change	2001	2002	Change	2001
Other expense, net	\$(6.8)	566%	\$(1.0)	\$(15.9)	196%	\$(5.4)

Other expense, net for the first six months of fiscal 2002 is comprised primarily of interest expense on our convertible subordinated notes and \$7.7 million of write-offs of certain non-marketable investments (including \$2.0 million in the fiscal 2002 second quarter), which we determined to be permanently impaired, partially offset by interest income on invested cash balances and gains on sales of assets.

Other expense, net for the first six months of fiscal 2001 is comprised primarily of a \$5.0 million write-off of certain non-marketable investments, which we determined to be permanently impaired, and net interest expense.

**Provision (Benefit) for Income Taxes**

As a result of our recent operating losses and our expectation of future operating results, we determined that it is more likely than not that the additional income tax benefits which arose during the first six months of fiscal 2002 will not be realized. Consequently, we have not recognized any income tax benefits relating to our fiscal 2002 operating loss. Our provision for income taxes for the second quarter and first six months of fiscal 2002 consists of foreign income taxes incurred by certain of our subsidiaries. For the first six months of fiscal 2001, we recorded an income tax benefit of \$152.2 million (24.5% of pretax loss), which reflects our net loss and the impact of non-deductible debt conversion costs and amortization of intangible assets.

We do not expect to recognize any income tax benefits relating to future operating losses until we believe that such benefits are more likely than not to be realized. Consequently, we expect our effective income tax rate will be approximately 0% for fiscal 2002.

**Extraordinary Item**

During the first quarter of fiscal 2001, we purchased \$35.0 million principal amount of our 4% Convertible Subordinated Notes due 2007 at prevailing market prices, resulting in a gain of \$11.7 million. Such gain has been presented in the accompanying statement of operations as an extraordinary item, net of incomes taxes of \$4.4 million.

**Pro Forma Earnings**

Pro forma loss before extraordinary item and pro forma loss per share before extraordinary item exclude the amortization of intangible assets, special charges, stock compensation and certain non-operating gains and losses. We believe these measures of earnings provide a better understanding of our underlying operating results and we use these measures internally to evaluate our operating performance. These measures of earnings are not in accordance with, or an alternative for, generally accepted accounting principles and may be different from pro forma measures used by other companies.



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Pro forma loss before extraordinary item and pro forma loss per share before extraordinary item are calculated as follows:

(in thousands, except per share data)	Three months ended March 31,		Six months ended March 31,	
	2002	2001	2002	2001
Loss before extraordinary item	\$ (200,702)	\$ (262,011)	\$ (405,192)	\$ (468,871)
Amortization of intangible assets	90,095	84,040	179,702	166,344
Special charges	21,384	11,848	22,384	19,775
Stock compensation	452	2,219	2,779	4,706
Equity in losses of equity method investees	1,113	1,862		
Gains on sales of assets	(2,613)	(5,150)		
Write-down of investments	2,000	7,675	5,000	
Debt conversion costs		42,584		
Income taxes	(23,550)	(14,409)		

Pro forma loss before extraordinary item  
 \$(88,271) \$(187,454) \$(195,940) \$(244,871)

Pro forma loss per share before extraordinary item, basic  
 and diluted  
 \$(0.34) \$(0.77) \$(0.77) \$(1.02)  
 Shares used in per share computation  
 256,135 243,515 255,249 239,813

Special charges excluded from our pro forma results consist of asset impairments, restructuring charges and separation costs incurred in connection with the proposed separation of our broadband access and Mindspeed Technologies businesses. Pro forma results also exclude stock compensation costs, representing the amortization of the value of certain stock options we assumed in connection with business acquisitions and



the incremental cost that results from the use of variable, rather than fixed, accounting for a stock-based incentive compensation plan. Under variable accounting, the amount of compensation expense we recognize for awards under the plan will fluctuate over time based upon changes in the value of our common stock. Non-operating gains and losses excluded from pro forma results consist of our equity in the losses of investments accounted for under the equity method, gains on sales of assets, the write-down of certain non-marketable investments and debt conversion costs. For the first six months of fiscal 2001, the pro forma results reflect an income tax benefit based upon a 36% effective tax rate.

### **Liquidity and Capital Resources**

Our cash and cash equivalents decreased by \$30.5 million during the first six months of fiscal 2002. Cash used in operating activities was \$105.5 million for the fiscal 2002 period, compared to cash used in operating activities of \$178.5 million for the comparable period in fiscal 2001. Operating cash flows reflect our net loss of \$405.2 million offset by noncash charges (depreciation and amortization and other) of \$267.1 million, and a net decrease in the non-cash components of working capital of \$32.6 million.

The fiscal 2002 working capital decreases include a \$26.9 million decrease in accounts receivable, principally due to our aggressive accounts receivable collection efforts, a \$22.8 million increase in accounts payable and a \$3.7 million decrease in inventories. These working capital changes were partially offset by a \$10.1 million decrease in deferred revenues due to lower inventory levels at our major distributors and changes in other assets and liabilities totaling \$10.9 million.

Cash provided by investing activities of \$64.7 million for the first six months of fiscal 2002 includes proceeds from net sales of marketable securities of \$49.3 million and proceeds from the sale of assets of \$41.7 million. Capital expenditures were \$19.5 million, reflecting implementation of our cost reduction initiatives. Other investing activities included equity investments of \$4.1 million and the payment of \$2.7 million of contingent consideration for a business acquired in fiscal 2000. Cash used in investing activities during the first six months of fiscal 2001 consisted of net purchases of marketable securities of \$253.7 million, capital expenditures of \$118.8 million, and payments for investments, advances and acquisitions totaling \$101.6 million.

Cash provided by financing activities of \$10.2 million during the first six months of fiscal 2002 consisted of proceeds from the exercise of stock options. In the first six months of fiscal 2001, cash used in financing activities consisted of \$65.0 million paid in connection with the conversion and repurchase of a portion of our convertible subordinated notes, offset by \$10.6 million in proceeds from the exercise of stock options.

Our principal sources of liquidity are our existing cash reserves and available-for-sale marketable securities and cash generated from operations. In addition, we expect the repayment of a refundable deposit, currently held by a vendor,

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will provide us an additional \$150 million of liquidity in the middle of calendar 2002. Combined cash and cash equivalents and marketable securities at March 31, 2002 totaled \$260.1 million compared to \$338.9 million at September 30, 2001. Our working capital at March 31, 2002 was \$455.2 million compared to \$442.4 million at September 30, 2001. The overall working capital change principally reflects the reclassification of the refundable deposit to current assets, offset by cash used in operations and cash payments for capital expenditures and investments.

Upon completion of the Merger, Alpha will purchase our semiconductor assembly and test facility, located in Mexicali, Mexico, and certain related assets, for \$150 million. We expect that Alpha will pay the purchase price by delivering to us a short-term promissory note under which 50% of the principal will be payable six months after the closing date, with the remainder payable nine months after the closing date. The note will bear interest at specified rates and will be secured by all current and future assets of Alpha and its subsidiaries, including the stock of Alpha and its subsidiaries. We cannot assure you that this transaction will be completed.

While the dramatic changes in end-user demand from the levels we experienced in fiscal 2000 and the continued high levels of channel inventories have reduced visibility into future demand, we expect that these and other factors will continue to affect our revenues in fiscal 2002. The reduced level of revenues in relation to our operating costs including our continued substantial investment in research and development will adversely affect our results of operations. Consequently, we anticipate that we will continue to experience negative cash flows from operations in the near term. During fiscal 2001 and 2002, we implemented a number of expense reduction initiatives, including workforce reductions, temporary shutdowns of our manufacturing facilities, the consolidation of certain facilities and salary reductions of 10% for senior management. We have also reduced our planned capital expenditures based upon our current revenue outlook.

We believe that our existing sources of liquidity, together with anticipated cash flows from the return of a refundable deposit and cash expected to be generated from operations will be sufficient to fund our operations, research and development efforts and anticipated capital expenditures for at least the next twelve months. Although reduced capital expenditures are a key component of our realigned manufacturing and procurement strategy, we will need to continue a focused program of capital expenditures to sustain our current manufacturing capabilities and to meet our research and development and corporate requirements. We may also consider acquisition opportunities to extend our technology portfolio and design expertise and to expand our product offerings. In order to fund renewed capital expenditures, increase our working capital or complete any acquisitions, we may seek to obtain additional debt financing or issue additional shares of our common stock. However, we cannot assure you that such financing will be available to us on favorable terms, or at all.

## **Recent Accounting Standards**

See Note 1 of Notes to Consolidated Condensed Financial Statements.

## **Critical Accounting Policies**

The preparation of financial statements in accordance with accounting principles generally accepted in the United States requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Among the significant estimates affecting our combined financial statements are those relating to allowances for doubtful accounts, inventories, long-lived assets, income taxes, warranties, restructuring costs and other contingencies. We regularly evaluate our estimates and assumptions based upon historical experience and various other factors that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. To the extent actual results differ from those estimates, our future results of operations may be affected.

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### ***Inventories***

We write down our inventory for estimated obsolescence or unmarketable inventory in an amount equal to the difference between the cost of inventory and the estimated market value based upon assumptions about future demand and market conditions. If actual market conditions are less favorable than our estimates, additional inventory write-downs may be required.

### ***Impairment of long-lived assets***

Long-lived assets, including fixed assets, goodwill and intangible assets, are continually monitored and are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of any such asset may not be recoverable. The determination of recoverability is based on an estimate of undiscounted cash flows expected to result from the use of an asset and its eventual disposition. The estimate of cash flows is based upon, among other things, certain assumptions about expected future operating performance. Our estimates of undiscounted cash flows may differ from actual cash flows due to, among other things, technological changes, economic conditions, changes to our business model or changes in our operating performance. If the sum of the undiscounted cash flows (excluding interest) is less than the carrying value, we recognize an impairment loss, measured as the amount by which the carrying value exceeds the fair value of the asset.

### ***Deferred income taxes***

We evaluate the realizability of our deferred tax assets and assess the need for a valuation allowance quarterly. We record a valuation allowance to reduce our deferred tax assets to the net amount that is more likely than not to be realized. Our assessment of the need for a valuation allowance is based upon our expectations of future taxable income and the ongoing prudent and feasible tax planning strategies available to us. Should we determine that we will not be able to realize all or part of our net deferred tax asset in the future, an adjustment to the deferred tax asset would be charged against income in the period such determination was made. Likewise, in the event we were to determine that we will be able to realize our deferred tax assets in the future in excess of its net recorded amount, an adjustment to the deferred tax asset would increase income in the period such determination was made.

### ***Allowance for doubtful accounts***

We maintain allowances for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. If the financial condition of our customers were to deteriorate, our actual losses may exceed our estimates, and additional allowances would be required.

### **Certain Business Risks**

Our business, financial condition and operating results can be impacted by a number of factors including, but not limited to, those set forth below, any one of which could cause our actual results to vary materially from recent results or from our anticipated future results.

You should carefully consider and evaluate all of the information in this Quarterly Report, including the risk factors listed below. Any of these risks could materially and adversely affect our business, financial condition and results of operations, which in turn could materially and adversely affect the price of our common stock or other securities.

### ***We have recently incurred substantial operating losses and we anticipate additional future losses.***

Our net revenues for the first six months of fiscal 2002 were \$470.6 million compared to \$661.4 million for first six months of fiscal 2001 due to sharply reduced end-customer demand in many of the communications electronics end-markets which our products address. We incurred a net loss of \$405.2 million in the first six months of fiscal 2002 and a net loss of \$1.4 billion for fiscal 2001.

During fiscal 2001 and continuing into fiscal 2002, we implemented a number of expense reduction and restructuring initiatives to more closely align our cost structure with the current business environment. The cost reduction initiatives include a worldwide workforce reduction, temporary shutdowns of our manufacturing facilities, significant reductions in capital spending, the consolidation of certain facilities and salary reductions for our senior management team until we return to profitability. However, these expense reduction initiatives alone will not return

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us to profitability. We expect that reduced end-customer demand, underutilization of our manufacturing capacity, changes in our revenue mix and other factors will continue to adversely affect our operating results in the near term and we anticipate incurring additional losses in fiscal 2002. In order to return to profitability, we must achieve substantial revenue growth and we currently face an environment of uncertain demand in the markets our products address. We cannot assure you as to whether or when we will return to profitability or whether we will be able to sustain such profitability, if achieved.

***We operate in the highly cyclical semiconductor industry, which is subject to significant downturns.***

The semiconductor industry is highly cyclical and is characterized by constant and rapid technological change, rapid product obsolescence and price erosion, evolving technical standards, short product life cycles and wide fluctuations in product supply and demand. From time to time these and other factors, together with changes in general economic conditions, cause significant upturns and downturns in the industry, and in our business in particular. Periods of industry downturns as we experienced in fiscal 2001 and continue to experience have been characterized by diminished product demand, production overcapacity, high inventory levels and accelerated erosion of average selling prices. These factors cause substantial fluctuations in our revenues and our results of operations. We have experienced these cyclical fluctuations in our business in the past and may experience cyclical fluctuations in the future.

During the late 1990 s and extending into 2000, the semiconductor industry in general, and communications applications in particular, enjoyed unprecedented growth, benefiting from the rapid expansion of the Internet and other communication services worldwide. During fiscal 2001 and 2002, we like many of our customers and competitors have been adversely impacted by a global economic slowdown and an abrupt decline in demand for many of the end-user products that incorporate our communications semiconductor products and system solutions. The impact of weakened end-customer demand has been compounded by higher-than-normal levels of equipment and component inventories among our OEM, subcontractor and distributor customers. As a result of this sharply reduced demand across our product portfolio, we recorded \$245.1 million of inventory write-downs in fiscal 2001. We expect that reduced levels of end-customer demand, changes in our revenue mix and other factors will continue to adversely affect our operating results in the near term.

In addition, an environment of weak end-customer demand and high levels of channel inventories has, in some cases, led to delays in payments for our products. During fiscal 2001, we recorded \$22.6 million of additional provisions for uncollectible accounts receivable from slow-paying customers. In the event that our customers delay payments to us, or are unable to pay amounts owed to us, we may incur additional losses on our accounts receivable.

Demand for our products in each of the communications electronics end-markets which we address is subject to a unique set of factors, and a downturn in demand affecting one market may be more pronounced, or last longer, than a downturn affecting another of our markets. In particular, demand for the products sold by our Mindspeed Technologies business, which are incorporated into telecommunications and data communications infrastructure equipment, is recovering more slowly than demand for products offered by our Personal Networking business, which are ultimately sold to individual consumers in products such as PCs and digital cellular handsets.

***We are subject to intense competition.***

The semiconductor industry in general and the markets in which we compete in particular are intensely competitive. We compete worldwide with a number of United States and international semiconductor manufacturers that are both larger and smaller than us in terms of resources and market share. We currently face significant competition in our markets and expect that intense price and product competition will continue. This competition has resulted and is expected to continue to result in declining average selling prices for our products. We also anticipate that additional competitors will enter our markets as a result of growth opportunities in communications electronics, the trend toward global expansion by foreign and domestic competitors, technological and public policy changes and relatively low barriers to entry in certain markets of the industry. Moreover, as with many companies in the semiconductor industry, customers for certain of our products offer other products that compete with similar products offered by us.

We believe that the principal competitive factors for semiconductor suppliers in our market are:

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time-to-market;  
product performance;  
level of integration;  
price and total system cost;  
compliance with industry standards;  
design and engineering capabilities;  
strategic relationships with customers;  
customer support;  
new product innovation; and  
quality.

The specific bases on which we compete vary by market. We cannot assure you that we will be able to successfully address these factors.

Many of our current and potential competitors have certain advantages over us, including:

longer presence in key markets;  
greater name recognition;  
access to larger customer bases; and

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

As a result, these competitors may be able to adapt more quickly to new or emerging technologies and changes in customer requirements or may be able to devote greater resources to the development, promotion and sale of their products than we can.

Current and potential competitors also have established or may establish financial or strategic relationships among themselves or with our existing or potential customers, resellers or other third parties. These relationships may affect customers' purchasing decisions. Accordingly, it is possible that new competitors or alliances among competitors could emerge and rapidly acquire significant market share. We cannot assure you that we will be able to compete successfully against current and potential competitors.

A number of our competitors have combined with each other and consolidated their businesses, including the consolidation of competitors with our customers. This is attributable to a number of factors, including the historically high-growth nature of the communications electronics industry and the time-to-market pressures on suppliers to decrease the time required for product conception, research and development, sampling and production launch before a product reaches the market. This consolidation trend is expected to continue, since investments, alliances and acquisitions may enable semiconductor suppliers, including us and our competitors, to augment technical capabilities or to achieve faster time-to-market for their products than would be possible solely through internal development.

Consolidation by industry participants is creating entities with increased market share, customer base, technology and marketing expertise in markets in which we compete. These developments may significantly and adversely affect our current markets, the markets we are seeking to serve and our ability to compete successfully in those markets.

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***Our success is dependent upon our ability to timely develop new products and reduce costs.***

Our operating results will depend largely on our ability to continue to introduce new and enhanced semiconductor products on a timely basis. Successful product development and introduction depends on numerous factors, including, among others:

- our ability to anticipate customer and market requirements and changes in technology and industry standards;
- our ability to accurately define new products;
- our ability to timely complete development of new products and bring our products to market on a timely basis;
- our ability to differentiate our products from offerings of our competitors; and
- overall market acceptance of our products.

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

In addition, prices of established products may decline, sometimes significantly, over time. We believe that in order to remain competitive we must continue to reduce the cost of producing and delivering existing products at the same time that we develop and introduce new or enhanced products. We cannot assure you that we will be able to continue to reduce the cost of our products to remain competitive.

***We may not be able to keep abreast of the rapid technological changes in our markets.***

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

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

Our products could become obsolete sooner than anticipated because of a faster than anticipated change in one or more of the technologies related to our products or in market demand for products based on a particular technology, particularly due to the introduction of new technology that represents a substantial advance over current technology. Currently accepted industry standards are also subject to change, which may contribute to the obsolescence of our products.

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

Our future success depends on our ability to continue to attract, retain and motivate qualified personnel, including executive officers and other key management and technical personnel. As the source of our technological and product innovations, our key technical personnel represent a significant asset. The competition for such personnel is intense in the semiconductor industry. We cannot assure you that we will be able to continue to attract and retain qualified management and other personnel necessary for the design, development, manufacture and sale of our products.

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We may have particular difficulty attracting and retaining key personnel during periods of poor operating performance, given, among other things, the significant use of equity-based compensation by our competitors and us. The loss of the services of one or more of our key employees, including Dwight W. Decker, our Chairman and Chief Executive Officer, or certain key design and technical personnel, or our inability to attract, retain and motivate qualified personnel could have a material adverse effect on our ability to operate our business.

***If OEMs of communications electronics products do not design our products into their equipment, we will be unable to sell those products. Moreover, a design win from a customer does not guarantee future sales to that customer.***

Our products are not sold directly to the end-user but are components of other products. As a result, we rely on OEMs of communications electronics products to select our products from among alternative offerings to be designed into their equipment. Without these design wins from OEMs, we would be unable to sell our products. Once an OEM designs another supplier's semiconductors into one of its product platforms, it will be more difficult for us to achieve future design wins with that OEM's product platform because changing suppliers involves significant cost, time, effort and risk. Achieving a design win with a customer does not ensure that we will receive significant revenues from that customer. Even after a design win, the customer is not obligated to purchase our products and can choose at any time to stop using our products if, for example, its own products are not commercially successful. We may be unable to achieve design wins or to convert design wins into actual sales.

***Because of the lengthy sales cycles of many of our products, we may incur significant expenses before we generate any revenues related to those products.***

Our customers may need six months or longer to test and evaluate our products and an additional six months or more to begin volume production of equipment that incorporates our products. The lengthy period of time required also increases the possibility that a customer may decide to cancel or change product plans, which could reduce or eliminate sales to that customer. As a result of this lengthy sales cycle, we may incur significant research and development, and selling, general and administrative expenses before we generate the related revenues for these products, and we may never generate the anticipated revenues if our customer cancels or changes its product plans.

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

Our sales are typically made pursuant to individual purchase orders and we generally do not have long-term supply arrangements with our customers. Generally, our customers may cancel orders until 30 days prior to shipment. In addition, we sell a portion of our products through distributors, some of whom have rights to return unsold products to us. Sales to distributors accounted for approximately 22% and 15% of our net revenues for fiscal 2001 and the first six months of fiscal 2002, respectively. We routinely purchase and manufacture inventory based on estimates of end-market demand for our customers' products, which is difficult to predict. This difficulty may be compounded when we sell to OEMs indirectly through distributors or contract manufacturers, or both, as our forecasts of demand are then based on estimates provided by multiple parties. In addition, our customers may change their inventory practices on short notice for any reason. The cancellation or deferral of product orders, the return of previously sold products or overproduction due to the failure of anticipated orders to materialize could result in our holding excess or obsolete inventory, which could result in write-downs of inventory.

During fiscal 2001, the communications electronics markets which we address were characterized by dramatic decreases in end-user demand and continued high levels of channel inventories that reduced visibility into future demand for our products. We expect that these and other factors will continue to affect our revenues in the near term. As a result of sharply reduced demand across our product portfolio, we recorded \$245.1 million of inventory write-downs in fiscal 2001.

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*We currently are, and increasingly will be, dependent upon third parties for the manufacture, assembly and test of our products.*

In March 2002 we contributed our Newport Beach wafer fabrication operations to Jazz Semiconductor, a joint venture in which we hold 45% ownership. As a result of this transaction, we are now dependent upon third parties, including Jazz Semiconductor, for the manufacture of all CMOS wafers used in our products. Moreover, upon completion of the Wireless Spin-off, we will contribute to Washington our Newbury Park gallium arsenide wafer fabrication facility. Upon completion of the Wireless Spin-off and Merger, we will be entirely dependent upon outside wafer fabrication facilities (known as foundries), including Jazz Semiconductor and Alpha, for wafer fabrication services. Under this fabless business model, our long-term revenue growth will be dependent on our ability to obtain sufficient external manufacturing capacity, including wafer production capacity. During times when the semiconductor industry is experiencing a shortage of wafer fabrication capacity, we may experience delays in shipments or increased manufacturing costs.

There are significant risks associated with our reliance on third-party foundries, including:

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

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

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

We have entered into long-term supply arrangements with major foundry partners, including Jazz Semiconductor, to obtain external wafer manufacturing capacity. In connection with the Wireless Spin-off and the Merger, we will also enter into a supply agreement with Alpha for the supply of specialty-process wafer fabrication services. However, these and other third-party foundries we use may allocate their limited capacity to fulfill their internal production requirements or the production requirements of other customers that are larger and better financed than we. If we choose to use a new foundry, it typically takes several months to complete the qualification process before we can begin shipping products from the new foundry. The foundries we use may experience financial difficulties or suffer damage or destruction to their facilities, particularly since many of them are located in earthquake zones. If these events or any other disruption of wafer fabrication capacity occur, we may not have a second manufacturing source immediately available. We may therefore experience difficulties or delays in securing an adequate supply of our products on favorable terms, or at all, which could impair our ability to meet our customers' needs and have a material adverse effect on our operating results.

In addition, the highly complex and technologically demanding nature of semiconductor manufacturing has caused foundries to experience from time to time lower than anticipated manufacturing yields, particularly in connection with the introduction of new products and the installation and start-up of new process technologies. Lower than anticipated manufacturing yields may affect our ability to fulfill our customers' demands for our products on a timely and cost-effective basis.

Currently, third-party subcontractors also assemble and test a substantial portion of our products. Moreover, upon completion of the Wireless Spin-off and the Merger, Alpha will purchase our Mexicali, Mexico assembly and test facility. As a result, we will no longer have internal assembly and test facilities and it will be necessary for us to obtain assembly and test services from third-party subcontractors, including Alpha. Because we rely on others to assemble and test our products, we are subject to many of the same risks as are described above with respect to independent wafer fabrication facilities.

*Our manufacturing processes are extremely complex and specialized.*

Our manufacturing operations are complex and subject to disruption due to causes beyond our control. The fabrication of integrated circuits is an extremely complex and precise process consisting of hundreds of separate steps. It requires production in a highly controlled, clean environment. Minute impurities, errors in any step of the fabrication process, defects in the masks used to print circuits on a wafer or a number of other factors can cause a substantial percentage of wafers to be rejected or numerous die on each wafer not to function.



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Our operations may be affected by lengthy or recurring disruptions of operations at any of our production facilities or those of our subcontractors. These disruptions may include labor strikes, work stoppages, electrical power outages, fire, earthquake, flooding or other natural disasters. Certain of our manufacturing facilities are located near major earthquake fault lines, including our California and Mexico facilities. We maintain no earthquake insurance coverage on these facilities. Disruptions of our or our subcontractors' manufacturing operations could cause significant delays in shipments until we could shift the products from an affected facility or subcontractor to another facility or subcontractor.

In the event of these types of delays, we cannot assure you that the required alternate capacity, particularly wafer production capacity, would be available on a timely basis or at all. Even if alternate wafer production capacity is available, we may not be able to obtain it on favorable terms, which could result in a loss of customers. We may be unable to obtain sufficient manufacturing capacity to meet demand.

Due to the highly specialized nature of the gallium arsenide semiconductor manufacturing process, in the event of a disruption at our Newbury Park, California wafer fabrication facility, alternate gallium arsenide production capacity would not be readily available from third-party sources. Although we have a multi-year agreement with another foundry that guarantees us access to additional gallium arsenide wafer production capacity, a disruption of operations at our Newbury Park wafer fabrication facility or an interruption in the supply of epitaxial wafers used in the gallium arsenide process could have a material adverse effect on our business, financial condition and results of operations, particularly with respect to our wireless communications products.

Other wafer manufacturing processes we rely on, including the silicon germanium process, are also highly specialized. In the event of a disruption at Jazz Semiconductor, we may be required to seek alternate specialty-process production capacity from other third-party sources. These processes are available from a limited number of third-party sources, including a foundry partner to whom we recently licensed our silicon germanium process technology. We cannot assure you that we would be able to obtain adequate external specialty-process wafer manufacturing capacity on favorable terms, or at all.

***We may not be able to achieve manufacturing yields that contribute positively to our gross margin and profitability.***

Our operating results are highly dependent upon our ability to produce integrated circuits at acceptable manufacturing yields. Minor deviations in the manufacturing process can cause substantial manufacturing yield loss, and in some cases, cause production to be suspended. Manufacturing yields for new products initially tend to be lower as we complete product development and commence volume manufacturing, and will typically increase as we ramp to full production. Our forward product pricing includes this assumption of improving manufacturing yields and, as a result, material variances between projected and actual manufacturing yields have a direct effect on our gross margin and profitability. The difficulty of forecasting manufacturing yields accurately and maintaining cost competitiveness through improving manufacturing yields will continue to be magnified by the ever-increasing process complexity of manufacturing semiconductor products. We also face pressures arising from the compression of product life cycles which requires us to bring new products to market faster and for shorter periods while maintaining acceptable manufacturing yields and quality without, in many cases, reaching the longer-term, high-volume manufacturing conducive to higher manufacturing yields and declining costs.

***We are dependent upon adequate supplies of raw materials and components.***

We believe there are adequate sources for the supply of raw materials and components for the manufacture of our products with suppliers located around the world. We are currently dependent on two suppliers for epitaxial wafers used in the gallium arsenide semiconductor manufacturing processes at our Newbury Park facility. Although in the past the number of qualified alternative suppliers for wafers has been limited and the process of qualifying a new wafer supplier has required a substantial lead-time, more epitaxial wafer capacity has recently become available and the supplier qualification process has become less lengthy and complex. Nevertheless, while we historically have not experienced any significant difficulties in obtaining an adequate supply of raw materials, including epitaxial wafers, and components necessary for the manufacture of our products, we cannot assure you that a significant supplier may not be lost or that a supplier may be unable to meet performance and quality specifications or delivery schedules.

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*Our success depends, in part, on our ability to effect suitable investments, alliances and acquisitions; we may have difficulty integrating companies we acquire.*

Although we invest significant resources in research and development activities, the complexity and rapidity of technological changes make it impractical for us to pursue development of all technological solutions on our own. On an ongoing basis, we review investment, alliance and acquisition prospects that would complement our existing product offerings, augment our market coverage or enhance our technological capabilities. However, we cannot assure you that we will be able to identify and consummate suitable investment, alliance or acquisition transactions in the future.

Moreover, if we consummate such transactions, they could result in:

issuances of equity securities dilutive to our existing shareholders;

large one-time write-offs;

the incurrence of substantial debt and assumption of unknown liabilities;

the potential loss of key employees from the acquired company;

amortization expenses related to intangible assets; and

the diversion of management's attention from other business concerns.

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

Integrating acquired organizations and their products and services may be expensive, time-consuming and a strain on our resources and our relationships with employees and customers, and ultimately may not be successful.

*We face a risk that capital needed for our business will not be available when we need it.*

We believe that our existing sources of liquidity, together with anticipated cash flows from the return of a refundable deposit and cash expected to be generated from operations will be sufficient to fund our research and development, capital expenditure, working capital and other financing requirements for at least the next twelve months. However, we cannot assure you that this will be the case and we may need to obtain alternate sources of financing in the future. We cannot assure you that we will have access to additional sources of capital on favorable terms or at all.

In addition, any strategic investments and acquisitions that we may make to help us grow our business may require additional capital resources. We cannot assure you that the capital required to fund these investments and acquisitions will be available in the future.

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

For fiscal 2001 and the first six months of fiscal 2002, approximately 71% and 89% of our net revenues, respectively, were from customers located outside the United States, primarily in the Asia-Pacific and European countries. In addition, we have facilities and suppliers located outside the United States, including our assembly and test facility in Mexicali, Mexico and third-party foundries located in the Asia-Pacific region. Our international sales and operations are subject to a number of risks inherent in selling and operating abroad. These include, but are not limited to, risks regarding:

currency exchange rate fluctuations;

local economic and political conditions;

disruptions of capital and trading markets;

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

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changes in legal or regulatory requirements;

limitations on the repatriation of funds;

difficulty in obtaining distribution and support;

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

tax laws; and

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

Because most of our international sales, other than sales to Japan (which are denominated principally in Japanese yen), are currently denominated in U.S. dollars, our products could become less competitive in international markets if the value of the U.S. dollar increases relative to foreign currencies. Moreover, we may be competitively disadvantaged relative to our competitors located outside the United States who may benefit from a devaluation of their local currency. We cannot assure you that the factors described above will not have a material adverse effect on our ability to increase or maintain our foreign sales.

Our past operating performance has been impacted by adverse economic conditions in the Asia-Pacific region, which have increased the uncertainty with respect to the long-term viability of certain of our customers and suppliers in the region. Sales to customers in Japan and other countries in the Asia-Pacific region, principally Taiwan, South Korea and Hong Kong, represented approximately 56% and 75% of our net revenues in fiscal 2001 and the first six months of fiscal 2002, respectively.

We enter into foreign currency forward exchange contracts, principally for the Japanese yen, to minimize risk of loss from currency exchange rate fluctuations for foreign currency commitments entered into in the ordinary course of business. We have not entered into foreign currency forward exchange contracts for other purposes and our financial condition and results of operations could be affected (negatively or positively) by currency fluctuations.

***Our operating results may be negatively affected by substantial quarterly and annual fluctuations and market downturns.***

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

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

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

production capacity levels and fluctuations in manufacturing yields;

availability and cost of products from our suppliers;

the gain or loss of significant customers;

our ability to develop, introduce and market new products and technologies on a timely basis;

new product and technology introductions by competitors;

changes in the mix of products produced and sold;

market acceptance of our products and our customers' products;

intellectual property disputes;

seasonal customer demand;

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

the timing and extent of product development costs.



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

### ***The value of our common stock may be adversely affected by market volatility.***

The trading price of our common stock fluctuates significantly. Since our common stock began trading publicly, the reported sale price of our common stock on the Nasdaq National Market has been as high as \$132.50 and as low as \$6.57 per share. This price may be influenced by many factors, including:

- our performance and prospects;
- the depth and liquidity of the market for our common stock;
- investor perception of us and the industry in which we operate;
- changes in earnings estimates or buy/sell recommendations by analysts;
- general financial and other market conditions; and
- domestic and international economic conditions.

In addition, public stock markets have experienced, and are currently experiencing, extreme price and trading volume volatility, particularly in the technology sectors of the market. This volatility has significantly affected the market prices of securities of many technology companies for reasons frequently unrelated to or disproportionately impacted by the operating performance of these companies. These broad market fluctuations may adversely affect the market price of our common stock.

### ***We may be subject to claims of infringement of third-party intellectual property rights or demands that we license third-party technology, which could result in significant expense and loss of our intellectual property rights.***

The semiconductor industry is characterized by vigorous protection and pursuit of intellectual property rights. From time to time, third parties have asserted and may in the future assert patent, copyright, trademark and other intellectual property rights to technologies that are important to our business and have demanded and may in the future demand that we license their technology. Any litigation to determine the validity of claims that our products infringe or may infringe these rights, including claims arising through our contractual indemnification of our customers, regardless of their merit or resolution, could be costly and divert the efforts and attention of our management and technical personnel. We cannot assure you that we would prevail in litigation given the complex technical issues and inherent uncertainties in intellectual property litigation. If litigation results in an adverse ruling we could be required to:

- pay substantial damages;
- cease the manufacture, use or sale of infringing products;
- discontinue the use of infringing technology;
- expend significant resources to develop non-infringing technology; or
- license technology from the third party claiming infringement, which license may not be available on commercially reasonable terms, or at all.

### ***If we are not successful in protecting our intellectual property rights, it may harm our ability to compete.***

We rely primarily on patent, copyright, trademark and trade secret laws, as well as nondisclosure and confidentiality agreements and other methods, to protect our proprietary technologies and processes. In addition, we often incorporate the intellectual property of our customers into our designs, and we have obligations with respect to the non-use and non-disclosure of their intellectual property. In the past, we have found it necessary to engage in litigation to enforce our intellectual property rights, to protect our trade secrets or to determine the validity and scope of proprietary rights of others, including our customers. We expect future litigation on similar grounds, which may

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require us to expend significant resources and to divert the efforts and attention of our management from our business operations. We cannot assure you that:

the steps we take to prevent misappropriation or infringement of our intellectual property or the intellectual property of our customers will be successful;

any existing or future patents will not be challenged, invalidated or circumvented; or

any of the measures described above would provide meaningful protection.

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

### ***We may be liable for penalties under environmental laws, rules and regulations, which could adversely impact our business.***

We use a variety of chemicals in our manufacturing operations and are subject to a wide range of environmental protection regulations in the United States and Mexico. While we have not experienced any material adverse effect on our operations as a result of such regulations, we cannot assure you that current or future regulations would not have a material adverse effect on our business, financial condition and results of operations.

In the United States, environmental regulations often require parties to fund remedial action regardless of fault. Consequently, it is often difficult to estimate the future impact of environmental matters, including potential liabilities. We cannot assure you that the amount of expense and capital expenditures that might be required to complete remedial actions and to continue to comply with applicable environmental laws will not have a material adverse effect on our business, financial condition and results of operations.

In connection with our spin-off from Rockwell, we assumed all liabilities in respect of environmental matters related to our current and former operations. We have been designated as a potentially responsible party and are 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 us. In addition, we are engaged in remediations of groundwater contamination at our Newbury Park, California wafer fabrication facility and our former Newport Beach, California wafer fabrication facility. We currently estimate the remaining costs for these remediations to be approximately \$3.4 million and have accrued for these costs as of March 31, 2002.

### ***Our management team is subject to a variety of demands for its attention.***

Our management currently faces a variety of challenges, including the implementation of our strategic manufacturing realignment, the implementation of our expense reduction and restructuring initiatives, the Wireless Spin-off and the Merger, and the anticipated separation of our broadband access and Mindspeed Technologies businesses. While we believe that we have sufficient management resources to execute each of these initiatives, we cannot assure you that we will have these resources or that our initiatives will be successfully implemented.

### ***Certain provisions in our organizational documents and rights agreement and Delaware law may make it difficult for someone to acquire control of us.***

We have established certain anti-takeover measures that may affect our common stock and convertible notes. Our restated certificate of incorporation, our by-laws, our rights agreement with Mellon Investor Services LLC, as rights agent, dated as of November 30, 1998, as amended, and the Delaware General Corporation Law contain several provisions that would make more difficult an acquisition of control of us in a transaction not approved by our board of directors. Our restated certificate of incorporation and by-laws include provisions such as:

the division of our board of directors into three classes to be elected on a staggered basis, one class each year;

the ability of our board of directors to issue shares of our preferred stock in one or more series without further authorization of our shareowners;

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a prohibition on shareowner action by written consent;

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

a requirement that a supermajority vote be obtained to remove a director for cause or to amend or repeal certain provisions of our restated certificate of incorporation or by-laws;

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

a fair price provision.

We also have a rights agreement which gives our shareowners certain rights that would substantially increase the cost of acquiring us in a transaction not approved by our board of directors.

In addition to the rights agreement and the provisions in our restated certificate of incorporation and by-laws, Section 203 of the Delaware General Corporation Law generally provides that a corporation shall not engage in any business combination with any interested shareowner during the three-year period following the time that such shareowner becomes an interested shareowner, unless a majority of the directors then in office approves either the business combination or the transaction that results in the shareowner becoming an interested shareowner or specified shareowner approval requirements are met.

**Table of Contents****ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

Our financial instruments include cash and cash equivalents, marketable securities and long-term debt. Our main investment objectives are the preservation of investment capital and the maximization of after-tax returns on our investment portfolio. Consequently, we invest with only high-credit-quality issuers and we limit the amount of our credit exposure to any one issuer. We do not use derivative instruments for speculative or investment purposes.

Our cash and cash equivalents are not subject to significant interest rate risk due to the short maturities of these instruments. As of March 31, 2002, the carrying value of our cash and cash equivalents approximates fair value.

Our marketable debt securities (consisting of commercial paper, corporate bonds and government securities) principally have remaining terms of two years or less. Consequently, such securities are not subject to significant interest rate risk. All of our marketable securities are classified as available for sale. As of March 31, 2002, unrealized gains and losses on these securities included in accumulated other comprehensive income were not significant.

Our long-term debt consists of convertible subordinated notes with interest at fixed rates. Consequently, we do not have significant cash flow exposure on our long-term debt. However, the fair value of our convertible subordinated notes is subject to significant fluctuation due to their convertibility into shares of our common stock.

The following table shows the fair values of our investments and long-term debt as of March 31, 2002:

(in millions)	<u>Carrying Value</u>	<u>Fair Value</u>
Cash and cash equivalents	\$ 151.8	\$ 151.8
Marketable debt securities		
108.3 108.3		
Long-term debt		
709.8 475.1		

We transact business in various foreign currencies, and we have established a foreign currency hedging program utilizing foreign currency forward exchange contracts to hedge certain foreign currency transaction exposures (principally the Japanese yen). Under this program, we seek to offset foreign currency transaction gains and losses with gains and losses on the forward contracts, so as to mitigate our overall risk of foreign transaction gains and losses. We do not enter into forward contracts for speculative or trading purposes.

At March 31, 2002, we held foreign currency forward exchange contracts (to sell Japanese yen at specified rates) having an aggregate notional amount of approximately 93.0 million yen, at a notional weighted-average exchange rate of approximately 133.35 yen to one dollar. The net unrealized gain/loss on the forward contracts outstanding at March 31, 2002 was not material to our consolidated financial statements.

Based on our overall currency rate exposure at March 31, 2002, a 10 percent change in currency rates would not have a significant effect on our consolidated financial position, results of operations or cash flows.



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**PART II. OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS**

On May 30, 1997, Klaus Holtz filed suit against Rockwell in the U.S. District Court for the Northern District of California for patent infringement relating to our modem products utilizing the V.42bis standard for data compression. On September 30, 1998, the Court barred any alleged damages arising before May 30, 1997. On December 17, 1998, the Court issued an order construing the claims of the patent. We filed a motion for Summary Judgment of Non-Infringement on February 22, 1999. A hearing was held thereon on June 14, 1999. On October 25, 1999, the Court found in our favor and the case was dismissed. On July 10, 2000, the District Court granted our motion to declare the case an exceptional case under 35 U.S.C. 285, and awarded us \$250,000. Mr. Holtz filed a notice of appeal to the court of appeals for the Federal Circuit, challenging the District Court's findings on claim construction, non-infringement and laches. We began collection efforts on the approximately \$275,000 owed to us by Mr. Holtz as a result of the litigation so far. On August 22, 2000, Mr. Holtz filed for bankruptcy protection under Chapter 7 of the bankruptcy laws in the State of California. The Federal Circuit appeals were placed under the control of the trustee in bankruptcy, and were stayed pending resolution of the bankruptcy. In the bankruptcy proceeding, Klaus Holtz contended that his interest in the patent in suit was transferred to a third party, IP Holdings, and that the patent and the appeal were therefore not subject to disposition by the trustee. We subsequently reached a settlement agreement with the trustee and IP Holdings to resolve this matter. This agreement, which was contested by Mr. Holtz, was approved by the Bankruptcy Court over Mr. Holtz's objection.

Various other lawsuits, claims and proceedings have been or may be instituted or asserted against us or our subsidiaries, including those pertaining to product liability, intellectual property, environmental, safety and health, and employment matters. In connection with our spin-off from Rockwell, we assumed responsibility for all current and future litigation (including environmental and intellectual property proceedings) against Rockwell or its subsidiaries in respect of the operations of the semiconductor systems business of Rockwell.

The outcome of litigation cannot be predicted with certainty and some lawsuits, claims or proceedings may be disposed of unfavorably to us. 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 our financial condition or results of operations. Based on our evaluation of matters which are pending or asserted and taking into account our reserves for such matters, we believe the disposition of such matters will not have a material adverse effect on our financial condition or results of operations.

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**ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

Our annual meeting of shareholders was held on February 27, 2002 in Los Angeles, California. At the meeting, the following matters were voted on by our shareholders and approved by the following votes:

	Shares Voted For	Shares Voted Against	Votes Withheld/ Abstentions
Election of directors:			
Richard M. Bressler	205,447,653	13,081,060	
Ralph J. Cicerone	215,161,108	3,367,605	
Proposal to approve amendments to the Directors Stock Plan	142,954,876	72,464,016	3,109,821
Proposal to approve the adoption by the Board of Directors of the 2001 Employee Stock Purchase Plan	205,550,365	10,837,303	2,141,045
Proposal to ratify the appointment of Deloitte & Touche LLP as our independent auditors	212,755,683	4,086,477	1,686,553

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**ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K**

(a) Exhibits:

2.1 Agreement  
and Plan of  
Reorganization  
dated as of  
December 16,  
2001, as  
amended as of  
April 12, 2002,  
by and among  
the Company,  
Washington  
and Alpha  
(excluding  
exhibits) 10.1  
Wafer Supply  
and Services  
Agreement  
dated as of  
March 30, 2002  
by and between  
Specialtysemi,  
Inc. and the  
Company.\* 12  
Statement re:  
Computation of  
Ratios

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\* Certain confidential portions of this Exhibit have been omitted pursuant to a request for confidential treatment. Omitted portions have been filed separately with the Securities and Exchange Commission.

(b) Reports on Form 8-K

Current Report on Form 8-K dated March 1, 2002, with respect to the Company's announcement of a definitive agreement with The Carlyle Group for the formation of a specialty wafer foundry company (Items 5 and 7).

Current Report on Form 8-K dated March 15, 2002, with respect to the Company's announcement of the completion of the formation of a new specialty wafer foundry company (Items 5 and 7).

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**SIGNATURES**

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.

CONEXANT SYSTEMS, INC.  
(Registrant)

Date: May 13, 2002 By /s/  
BALAKRISHNAN S. IYER

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Balakrishnan S. Iyer  
Senior Vice President and  
Chief Financial Officer  
(principal financial officer) Date:  
May 13, 2002 By /s/ J. SCOTT  
BLOUIN

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J. Scott Blouin  
Senior Vice President and  
Chief Accounting Officer  
(principal accounting officer)

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**EXHIBIT INDEX**

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Inc. and the  
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