

CONEXANT SYSTEMS INC

Form 10-Q

February 05, 2004

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

FORM 10-Q

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

For the quarterly period ended December 31, 2003*

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.)

**4000 MacArthur Boulevard
Newport Beach, California 92660-3095**
(Address of principal executive offices) (Zip code)

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

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

Yes [X] No []

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

Yes [X] No []

Number of shares of registrant's common stock outstanding as of January 30, 2004 was 280,357,286.

* For presentation purposes of this Form 10-Q, references made to the December 31, 2003 period relate to the actual fiscal first quarter ended January 2, 2004.

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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; changes in product mix; product obsolescence; the availability of manufacturing capacity; fluctuations in manufacturing yields; pricing pressures and other competitive factors; our ability to develop and implement new technologies and to obtain protection of the related intellectual property; the uncertainty of litigation; our ability to attract and retain qualified personnel; costs related to our proposed merger with GlobespanVirata, Inc.; successful completion of our proposed merger with GlobespanVirata; and the risk that our and GlobespanVirata's businesses will not be successfully integrated, as well as other risks and uncertainties, including 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.

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

| | December 31, 2003 | September 30, 2003 |
|--|----------------------|-----------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 89,762 | \$ 76,186 |
| Short-term investments | 98,550 | 99,283 |
| Receivables, net of allowance of \$1,536 and \$1,547 at December 31, 2003 and September 30, 2003, respectively | 85,614 | 79,557 |
| Inventories | 58,979 | 59,548 |
| Deferred income taxes | 13,641 | 13,600 |
| Mindspeed warrant-current portion | 21,350 | |
| Other current assets | 27,917 | 26,524 |
| | <hr/> | <hr/> |
| Total current assets | 395,813 | 354,698 |
| Property, plant and equipment, net | 37,739 | 36,310 |
| Goodwill | 56,865 | 56,865 |
| Intangible assets, net | 11,550 | 12,506 |
| Deferred income taxes | 241,440 | 241,260 |
| Mindspeed warrant | 122,510 | 119,230 |
| Other assets | 121,593 | 110,838 |
| | <hr/> | <hr/> |
| Total assets | \$ 987,510 | \$ 931,707 |
| | <hr/> | <hr/> |
| LIABILITIES AND SHAREHOLDERS EQUITY | | |
| Current liabilities: | | |
| Accounts payable | \$ 68,092 | \$ 55,909 |
| Accrued compensation and benefits | 30,990 | 28,865 |
| Other current liabilities | 34,227 | 36,907 |
| | <hr/> | <hr/> |
| Total current liabilities | 133,309 | 121,681 |
| Convertible subordinated notes | 581,825 | 581,825 |
| Other liabilities | 58,772 | 61,435 |
| | <hr/> | <hr/> |
| Total liabilities | 773,906 | 764,941 |
| | <hr/> | <hr/> |
| Commitments and contingencies | | |
| Shareholders equity: | | |
| Preferred and junior preferred stock | | |
| Common stock, \$0.01 par value: 1,000,000 shares authorized; 278,206 and 276,134 shares issued at December 31, 2003 and September 30, 2003, respectively | 2,782 | 2,761 |
| Additional paid-in capital | 3,511,951 | 3,506,070 |
| Accumulated deficit | (3,291,880) | (3,332,527) |
| Accumulated other comprehensive loss | (9,232) | (9,496) |
| Unearned compensation | (17) | (42) |

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| | | |
|--|-------------------|-------------------|
| Total shareholders' equity | <u>213,604</u> | <u>166,766</u> |
| Total liabilities and shareholders' equity | <u>\$ 987,510</u> | <u>\$ 931,707</u> |

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 December 31, | |
|--|------------------------------------|--------------|
| | 2003 | 2002 |
| Net revenues | \$ 177,333 | \$ 144,201 |
| Cost of goods sold | 98,196 | 81,462 |
| Gross margin | 79,137 | 62,739 |
| Operating expenses: | | |
| Research and development | 39,154 | 40,237 |
| Selling, general and administrative | 22,809 | 22,779 |
| Amortization of intangible assets | 955 | 799 |
| Special charges | 605 | 6,774 |
| Total operating expenses | 63,523 | 70,589 |
| Operating income (loss) | 15,614 | (7,850) |
| Other income, net | 25,281 | 3,403 |
| Income (loss) before income taxes | 40,895 | (4,447) |
| Provision for income taxes | 248 | 316 |
| Income (loss) from continuing operations | 40,647 | (4,763) |
| Loss from discontinued operations, net of income taxes | | (620,610) |
| Net income (loss) | \$ 40,647 | \$ (625,373) |
| Income (loss) per share, basic: | | |
| Continuing operations | \$ 0.15 | \$ (0.02) |
| Discontinued operations | | (2.33) |
| Net income (loss) | \$ 0.15 | \$ (2.35) |
| Number of shares used in per share computation-basic | 277,190 | 265,714 |
| Income (loss) per share, diluted: | | |
| Continuing operations | \$ 0.13 | \$ (0.02) |
| Discontinued operations | | (2.33) |
| Net income (loss) | \$ 0.13 | \$ (2.35) |
| Number of shares used in per share computation-diluted | 307,545 | 265,714 |

See accompanying notes to consolidated condensed financial statements.

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

| | Three months ended December 31, | |
|--|------------------------------------|------------|
| | 2003 | 2002 |
| Cash flows from operating activities: | | |
| Income (loss) from continuing operations | \$ 40,647 | \$ (4,763) |
| Adjustments to reconcile income (loss) from continuing operations to net cash provided by (used in) operating activities, net of effects of disposition of business: | | |
| Depreciation | 3,155 | 5,540 |
| Amortization of intangible assets | 955 | 799 |
| Asset impairments | 153 | 2,196 |
| Provision for losses on accounts receivable | | (2,432) |
| Inventory provisions | 1,644 | 6,384 |
| Change in fair value of Skyworks note and Mindspeed warrant | (19,719) | (4,029) |
| Equity in earnings of equity method investees | (10,165) | (1,303) |
| Other non-cash items, net | 235 | 3,459 |
| Changes in assets and liabilities: | | |
| Receivables | (6,057) | 81 |
| Inventories | (1,075) | (19,132) |
| Accounts payable | 12,074 | (9,130) |
| Accrued expenses and other current liabilities | 3,445 | 1,233 |
| Other | (2,976) | 6,985 |
| | 22,316 | (14,112) |
| Cash flows from investing activities: | | |
| Advances to Skyworks | | (35,000) |
| Repayment of Term Notes and advances by Skyworks | | 170,000 |
| Purchase of marketable securities | (12,580) | (10,792) |
| Sale of marketable securities | 8,266 | 1,106 |
| Capital expenditures | (4,857) | (3,197) |
| Proceeds from sales of assets | 269 | 1,000 |
| Deferred merger costs | (1,432) | |
| Payment of deferred purchase consideration | (4,000) | |
| Investments in and advances to businesses | (471) | (1,500) |
| | (14,805) | 121,617 |
| Cash flows from financing activities: | | |
| Proceeds from exercise of stock options | 6,065 | 749 |
| | 6,065 | 749 |
| Net cash provided by financing activities | | |
| | 6,065 | 749 |
| Net cash used in discontinued operations | | (43,433) |
| | 6,065 | (43,433) |
| Net increase in cash and cash equivalents | 13,576 | 64,821 |
| Cash and cash equivalents at beginning of period | 76,186 | 161,088 |
| | 89,762 | 225,909 |
| Cash and cash equivalents at end of period | \$ 89,762 | \$ 225,909 |

See accompanying notes to consolidated condensed financial statements.

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

1. Basis of Presentation and Significant Accounting Policies

Conexant Systems, Inc. (Conexant or the Company) designs, develops and sells semiconductor system solutions for use in products driving broadband digital home information and entertainment applications. The Company's solutions connect the client, or end-customer, side of personal communications access products such as personal computers (PCs), set-top boxes and game consoles to audio, video, voice and data services over broadband and dial-up Internet connections. In addition, the Company's media processing products enable the capture, display, storage, playback and transfer of audio and video content in applications throughout the digital home and small office environments. The Company operates in one segment.

On June 27, 2003, Conexant completed the distribution to Conexant shareholders of all outstanding shares of Mindspeed Technologies, Inc. (Mindspeed), a wholly owned subsidiary of Conexant to which Conexant contributed its Internet infrastructure business, including the stock of certain subsidiaries, and certain other assets and liabilities, including approximately \$100.0 million in cash (hereinafter, the Mindspeed Spin). In the Mindspeed Spin, Conexant shareholders received one share of Mindspeed common stock for every three Conexant shares held and the Conexant shareholders continued to hold their Conexant shares. Mindspeed issued to Conexant a warrant to purchase 30 million shares of Mindspeed common stock, representing approximately 20 percent of Mindspeed's outstanding common stock on a fully diluted basis. The warrant is exercisable for a period of ten years, commencing one year after the completion of the Mindspeed Spin, at an exercise price of \$3.408 per share (the fair market value on the date of grant). The warrant is recorded as an asset on the consolidated condensed balance sheet (see Note 2). Additionally, Conexant entered into a senior secured revolving credit facility pursuant to which Mindspeed may borrow up to \$50.0 million for working capital and general corporate purposes (see Note 9).

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

| | Three months ended December 31, 2002 |
|--|---|
| Net revenues | \$ 20,255 |
| Loss before income taxes | \$ (47,306) |
| Provision for income taxes | 120 |
| Cumulative effect of change in accounting for goodwill | (573,184) |
| Loss from discontinued operations | \$(620,610) |

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 special charges, necessary to present fairly the Company's financial position, results of operations and cash flows. The results of operations for interim periods are not necessarily indicative of the results that may be expected for a full year. These statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended September 30, 2003.

Pending Merger with GlobespanVirata, Inc. On November 3, 2003, the Company entered into a definitive merger agreement with GlobespanVirata, Inc., a provider of broadband communications solutions for consumer, enterprise, personal computer and service provider markets. In the merger, GlobespanVirata shareholders will receive 1.198 shares of Conexant common stock for each share of GlobespanVirata common stock. This transaction will be accounted for under the purchase method of accounting with the Company as the acquirer for accounting purposes. The closing of the transaction is subject to shareholder approvals. Shareholders of both companies will vote on the proposed merger at their respective meetings to be held on February 25, 2004. It is expected that the transaction will be completed promptly after obtaining such approvals.

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

Fiscal Periods For presentation purposes, references made to the periods ended December 31, 2003 and 2002 relate to the actual fiscal 2004 first quarter ended January 2, 2004 and the actual fiscal 2003 first quarter ended December 27, 2002, respectively.

Supplemental Cash Flow Information Cash paid for interest was \$1.4 million for each of the three months ended December 31, 2003 and 2002. Cash paid for income taxes for the three months ended December 31, 2003 and 2002 was \$0.6 million and \$0.3 million, respectively.

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

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

| | Three months ended December 31, | |
|---|------------------------------------|--------------|
| | 2003 | 2002 |
| Numerator (dollars in thousands): | | |
| Income (loss) from continuing operations | \$ 40,647 | \$ (4,763) |
| Discontinued operations, net of income taxes | | (620,610) |
| | 40,647 | (625,373) |
| Effect of assumed conversion of 4.25% Convertible Subordinated Notes | 439 | |
| | \$ 41,086 | \$ (625,373) |
| Denominator (weighted-average number of shares, in thousands): | | |
| Weighted average shares outstanding- Basic | 277,190 | 265,714 |
| Stock options and warrant (under the treasury stock method) | 22,973 | |
| Restricted stock | 18 | |
| Assumed conversion of 4.25% Convertible Subordinated Notes | 7,364 | |
| | 307,545 | 265,714 |

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

| | Three months ended December 31, | |
|---|------------------------------------|--------|
| | 2003 | 2002 |
| (weighted-average number of shares, in thousands) | | |
| Stock options and warrant (under the treasury stock method) | | 659 |
| 4.25% Convertible Subordinated Notes due 2006 | | 5,897 |
| 4% Convertible Subordinated Notes due 2007 | 12,137 | 11,607 |
| Restricted stock | | 108 |

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

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

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

| | Three months ended December 31, | |
|---|------------------------------------|-------------|
| | 2003 | 2002 |
| Income (loss) from continuing operations, as reported | \$ 40,647 | \$ (4,763) |
| Add: total expense determined under fair value accounting for all awards | (13,602) | (22,640) |
| Pro forma income (loss) from continuing operations | \$ 27,045 | \$ (27,403) |
| Income (loss) from continuing operations per share - basic, as reported | \$ 0.15 | \$ (0.02) |
| Pro forma income (loss) from continuing operations per share - basic | \$ 0.10 | \$ (0.10) |
| Income (loss) from continuing operations per share - diluted, as reported | \$ 0.13 | \$ (0.02) |
| Pro forma income (loss) from continuing operations per share - diluted | \$ 0.09 | \$ (0.10) |

For purposes of pro forma disclosures under SFAS No. 123, the estimated fair value of the stock-based awards is assumed to be amortized to expense over the instruments' vesting period. The fair value has been estimated at the date of grant using the Black-Scholes option valuation model with the following assumptions for the three months ended December 31:

| | 2003 | 2002 |
|--|--------|--------|
| Risk-free interest rate | 3.3% | 3.2% |
| Expected volatility | 97% | 97% |
| Dividend yield | | |
| Expected life (years) | 4.5 | 4.5 |
| Weighted-average fair value of options granted | \$4.23 | \$1.27 |

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

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

Recent Accounting Standards In January 2003 the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. (FIN) 46, Consolidation of Variable Interest Entities, which was amended in December 2003. The Company must adopt FIN 46 in the second quarter ending March 2004 and does not expect the adoption to have a significant impact on its financial position or results of operations.

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

2. Supplemental Financial Statement Data**Short-term Investments**

Short-term investments consist of available-for-sale securities as follows (in thousands):

| | Amortized Cost | Gross Unrealized Holding Gains | Gross Unrealized Holding Losses | Fair Value |
|--|-------------------|---|--|-----------------|
| December 31, 2003: | | | | |
| U.S. government agencies | \$ 18,024 | \$ 9 | \$ (34) | \$ 17,999 |
| Foreign government securities | 2,543 | 7 | | 2,550 |
| Corporate debt securities | 22,002 | 27 | (56) | 21,973 |
| Skyworks 15% convertible senior subordinated notes | 46,910 | 4,113 | | 51,023 |
| Equity securities | 2,320 | 2,685 | | 5,005 |
| | <u>\$91,799</u> | <u>\$ 6,841</u> | <u>\$ (90)</u> | <u>\$98,550</u> |
| September 30, 2003: | | | | |
| U.S. government agencies | \$ 14,640 | \$ 25 | \$ (18) | \$ 14,647 |
| Foreign government securities | 2,044 | 15 | | 2,059 |
| Corporate debt securities | 21,625 | 74 | (59) | 21,640 |
| Skyworks 15% convertible senior subordinated notes | 46,542 | 9,024 | | 55,566 |
| Equity securities | 2,320 | 3,051 | | 5,371 |
| | <u>\$87,171</u> | <u>\$ 12,189</u> | <u>\$ (77)</u> | <u>\$99,283</u> |

The Company accounts for the 15% convertible senior subordinated notes issued by Skyworks Solutions, Inc. (Skyworks) as available-for-sale securities carried at their fair value. Unrealized gains or losses resulting from changes in the fair value of the underlying debt are included in other comprehensive income. The right to convert the Skyworks 15% convertible senior subordinated notes into shares of Skyworks common stock is, for financial accounting purposes, an embedded derivative instrument. Changes in the fair value of the Skyworks 15% convertible senior subordinated notes resulting from changes in the value of the conversion right are included in other income (expense), net each period.

Inventories

Inventories consist of the following (in thousands):

| | December 31, 2003 | September 30, 2003 |
|-----------------|----------------------|-----------------------|
| Work-in-process | \$36,463 | \$42,662 |
| Finished goods | 22,516 | 16,886 |
| | <u>\$58,979</u> | <u>\$59,548</u> |

Goodwill

During the first quarter of fiscal 2004, goodwill was not adjusted.

Intangible Assets

Intangible assets consist of the following (in thousands):

| | December 31, 2003 | | | September 30, 2003 | | |
|-------------------------|-------------------|--------------------------|------------------|--------------------|--------------------------|------------------|
| | Gross Asset | Accumulated Amortization | Net | Gross Asset | Accumulated Amortization | Net |
| Developed technology | \$ 15,904 | \$ (7,991) | \$ 7,913 | \$ 15,904 | \$ (7,456) | \$ 8,448 |
| Customer base | 2,050 | (480) | 1,570 | 2,050 | (358) | 1,692 |
| Other intangible assets | 7,443 | (5,376) | 2,067 | 7,443 | (5,077) | 2,366 |
| | <u>\$ 25,397</u> | <u>\$(13,847)</u> | <u>\$ 11,550</u> | <u>\$ 25,397</u> | <u>\$(12,891)</u> | <u>\$ 12,506</u> |

Intangible assets are amortized over a weighted-average period of approximately five years. Annual amortization expense, exclusive of the impact of the pending merger with GlobespanVirata, is expected to be as follows (in thousands):

| | 2004 | 2005 | 2006 | 2007 | 2008 |
|----------------------|----------|----------|----------|----------|----------|
| Amortization expense | \$ 3,822 | \$ 2,627 | \$ 1,804 | \$ 1,805 | \$ 1,564 |

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

Mindspeed Warrant

The Company accounts for the Mindspeed warrant as a derivative instrument, and changes in the fair value of the warrant are included in other income (expense), net each period. At December 31, 2003, the fair value of the Mindspeed warrant included on the accompanying consolidated condensed balance sheet was \$143.9 million. The current portion of \$21.4 million was determined using current pricing data, and the remaining portion was valued using a Black-Scholes model with the term of the warrant varying from 1 to 5 years to coincide with the Company's intent and ability to liquidate the warrant in installments, volatility of 90%, a risk-free interest rate of 3.2% and no dividend yield. It is the Company's intent to liquidate the portion of the warrant classified as current in the next twelve months.

Other Income (Expense), Net

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

| | Three months ended December 31, | |
|--|------------------------------------|----------|
| | 2003 | 2002 |
| Investment and interest income | \$ 2,497 | \$ 5,649 |
| Change in fair value of Skyworks 15% convertible senior subordinated notes | (4,911) | 4,029 |
| Change in fair value of the Mindspeed warrant | 24,630 | |
| Interest expense | (6,689) | (7,588) |
| Equity in earnings of equity method investees | 10,165 | 1,303 |
| Other | (411) | 10 |
| | \$25,281 | \$ 3,403 |

During the quarter ended December 31, 2003, an unrelated party paid a \$30.0 million note receivable for a previous equity investment in an entity in which the Company owns a 38% interest. In accordance with Staff Accounting Bulletin No. 51, the Company recognized an \$11.4 million gain upon the payment of this note, which is included in equity in earnings of equity method investees.

3. Skyworks Notes

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

Skyworks may redeem the 15% convertible senior subordinated notes at any time after May 12, 2004, subject to a redemption premium of 3% of the outstanding principal amount. The Company may, at its option, convert the outstanding principal amount of the 15% convertible senior subordinated notes into shares of Skyworks common stock based upon the conversion price (initially \$7.87 per share, subject to adjustment under certain circumstances). At maturity, Skyworks must pay the outstanding principal amount by delivery of a number of shares of its common stock based upon the conversion price. Skyworks has granted the Company certain registration rights relating to the 15% convertible senior subordinated notes and the shares of Skyworks common stock underlying the 15% convertible senior subordinated notes.

As of December 31, 2003, the 15% convertible senior subordinated notes are carried at their fair value of \$51.0 million (including the \$6.6 million fair value of the related conversion right) and are included in short-term investments in the accompanying consolidated condensed balance sheet because the Company has the ability and intent to liquidate the 15% convertible senior subordinated notes or shares underlying the

notes within the next twelve months.

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

4. Contingent Liabilities

Certain claims have been asserted against the Company, including claims alleging the use of the intellectual property rights of others in certain of the Company's products. The resolution of these matters may entail the negotiation of a license agreement, a settlement, or the resolution of such claims through arbitration or litigation. In connection with its spin-off from Rockwell International Corporation, now named Rockwell Automation, Inc. (Rockwell), Conexant 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 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.

Conexant has been designated as a potentially responsible party and is engaged in groundwater remediation at one Superfund site located at a former silicon wafer manufacturing facility and steel fabrication plant in Parker Ford, Pennsylvania formerly occupied by the Company. In addition, the Company is engaged in remediation of groundwater contamination at its former Newport Beach, California wafer fabrication facility. Management currently estimates the aggregate remaining costs for these remediations to be approximately \$3.2 million and has accrued for these costs as of December 31, 2003.

At December 31, 2003, the Company is contingently liable for approximately \$33.4 million in operating lease commitments on facility leases that were assigned to Mindspeed and Skyworks at the time of their separation from the Company.

5. Comprehensive Income (Loss)

Comprehensive income (loss) is as follows (in thousands):

| | Three months ended December 31, | |
|---|------------------------------------|-------------|
| | 2003 | 2002 |
| Net income (loss) | \$40,647 | \$(625,373) |
| Other comprehensive income (loss): | | |
| Foreign currency translation adjustments | 458 | 2,135 |
| Change in unrealized gains on available-for-sale securities | (451) | 2,048 |
| Minimum pension liability adjustments | 86 | 1,562 |
| Effect of income taxes | 172 | |
| Other comprehensive income | 265 | 5,745 |
| Comprehensive income (loss) | \$40,912 | \$(619,628) |

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

| December 31, 2003 | September 30, 2003 |
|----------------------|-----------------------|
|----------------------|-----------------------|

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| | | |
|---|-------------------|-------------------|
| Foreign currency translation adjustments | \$ (2,566) | \$ (3,023) |
| Unrealized gains on available-for-sale securities, net of tax | 1,628 | 1,907 |
| Minimum pension liability adjustments | (8,294) | (8,380) |
| | <u> </u> | <u> </u> |
| Accumulated other comprehensive loss | \$ (9,232) | \$ (9,496) |
| | <u> </u> | <u> </u> |

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CONEXANT SYSTEMS, INC.
NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS
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6. Special Charges

Special charges consist of the following (in thousands):

| | Three months ended December 31, | |
|-----------------------|------------------------------------|----------|
| | 2003 | 2002 |
| Asset impairments | \$ 153 | \$ 2,196 |
| Restructuring charges | 448 | 1,904 |
| Other special charges | 4 | 2,674 |
| | \$ 605 | \$ 6,774 |
| | \$ 605 | \$ 6,774 |

Asset Impairments

During the first fiscal quarter of 2003, the Company recorded impairment charges of \$2.2 million, related to leasehold improvements associated with properties no longer occupied by the Company and other assets that management determined to abandon or scrap.

Restructuring Charges

In fiscal 2001 and continuing into fiscal 2003, the Company implemented a number of cost reduction initiatives to improve its operating cost structure. The cost reduction initiatives included workforce reductions, temporary shutdowns of the Company's manufacturing facilities, significant reductions in capital spending, the closure or consolidation of certain facilities and salary reductions for the senior management team until the Company returned to profitability. The costs and expenses associated with the restructuring activities are included in special charges in the accompanying consolidated condensed statements of operations.

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

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

Activity and liability balances related to the 2002 Corporate and Manufacturing Restructuring Plan through December 31, 2003 were as follows (in thousands):

| Workforce reductions | Facility and other | Total |
|-------------------------|-----------------------|-------|
|-------------------------|-----------------------|-------|

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| | | | |
|---|-------------------|-------------------|-------------------|
| Charged to costs and expenses | \$ 2,437 | \$ 12,519 | \$ 14,956 |
| Cash payments | (1,664) | (431) | (2,095) |
| | <u> </u> | <u> </u> | <u> </u> |
| Restructuring balance, September 30, 2002 | 773 | 12,088 | 12,861 |
| Charged to costs and expenses | 2,898 | 888 | 3,786 |
| Expense reversal | | (1,100) | (1,100) |
| Cash payments | (3,173) | (3,930) | (7,103) |
| | <u> </u> | <u> </u> | <u> </u> |
| Restructuring balance, September 30, 2003 | 498 | 7,946 | 8,444 |
| Cash payments | (124) | (1,138) | (1,262) |
| | <u> </u> | <u> </u> | <u> </u> |
| Restructuring balance, December 31, 2003 | \$ 374 | \$ 6,808 | \$ 7,182 |
| | <u> </u> | <u> </u> | <u> </u> |

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2003 Corporate Restructuring Plan In the fourth quarter of fiscal 2003, the Company initiated another workforce reduction, closed a design center and consolidated some facilities. The Company involuntarily terminated approximately 35 employees in the sales and administration areas and recorded charges aggregating \$1.2 million based upon estimates of the cost of severance benefits for the affected employees. The Company also recorded restructuring costs of \$2.8 million relating to the consolidation of certain facilities under non-cancelable leases which were vacated. In the first quarter of fiscal 2004, as a continuation of the 2003 Corporate Restructuring Plan, the Company vacated an additional facility and involuntarily terminated additional employees, which resulted in an additional \$0.5 million in restructuring expense.

Activity and liability balances related to the 2003 Corporate Restructuring Plan through December 31, 2003 were as follows (in thousands):

| | <u>Workforce reductions</u> | <u>Facility and other</u> | <u>Total</u> |
|---|---------------------------------|-------------------------------|--------------|
| Charged to costs and expenses | \$ 1,181 | \$ 2,830 | \$ 4,011 |
| Cash payments | (364) | | (364) |
| | <u>817</u> | <u>2,830</u> | <u>3,647</u> |
| Restructuring balance, September 30, 2003 | 817 | 2,830 | 3,647 |
| Charged to costs and expenses | 350 | 98 | 448 |
| Cash payments | (681) | (334) | (1,015) |
| | <u>486</u> | <u>2,594</u> | <u>3,080</u> |
| Restructuring balance, December 31, 2003 | \$ 486 | \$ 2,594 | \$ 3,080 |

Through December 31, 2003, the Company has paid an aggregate of \$28.4 million in connection with all of its restructuring plans and has a remaining accrued restructuring balance of \$10.3 million. The Company expects to pay the amounts accrued for the workforce reductions during fiscal 2004 and expects to pay the obligations for the non-cancelable lease and other commitments over their respective terms, which expire through fiscal 2006. Cash payments to complete the restructuring actions will be funded from available cash reserves and funds from product sales, and are not expected to significantly impact the Company's liquidity.

Other Special Charges

Other special charges in the first fiscal quarter of 2003 principally consist of a \$2.7 million loss on the sale of certain semiconductor test equipment.

7. Segment Information

The Company operates and tracks its results in one segment (see Note 1).

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

| | Three months ended December 31, | |
|--------------------------------|--|-------------------|
| | 2003 | 2002 |
| Americas | \$ 22,401 | \$ 19,232 |
| Asia-Pacific | 140,362 | 113,113 |
| Europe, Middle East and Africa | 14,570 | 11,856 |
| | <u>\$ 177,333</u> | <u>\$ 144,201</u> |

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The Company believes a substantial portion of the products sold to original equipment manufacturers (OEMs) and third-party manufacturing service providers in the Asia-Pacific region are ultimately shipped to end-markets in the Americas and Europe. For the three months ended December 31, 2003, one customer (a foreign distributor) accounted for 14% of net revenues and for the three months ended December 31, 2002, one customer (a foreign distributor) accounted for 13% of net revenues. No other customer accounted for 10% or more of the Company's net revenues for the three months ended December 31, 2003 or 2002.

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8. Guarantees

The Company has made guarantees and indemnities, under which it may be required to make payments to a guaranteed or indemnified party, in relation to certain transactions. In connection with the Company's spin-off from Rockwell, the Company assumed responsibility for all contingent liabilities and then 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. In connection with the Company's contribution of certain of its manufacturing operations to Jazz Semiconductor, Inc. (Jazz), the Company agreed to indemnify Jazz for certain environmental matters and other customary divestiture-related matters. In connection with the sales of its products, the Company provides intellectual property indemnities to its customers. In connection with certain facility leases, the Company has indemnified its lessors for certain claims arising from the facility or the lease. The Company indemnifies its directors and officers to the maximum extent permitted under the laws of the State of Delaware. The duration of the guarantees and indemnities varies, and in many cases is indefinite. The guarantees and indemnities to customers in connection with product sales generally are subject to limits based upon the amount of the related product sales. The majority of other guarantees and indemnities do not provide for any limitation of the maximum potential future payments the Company could be obligated to make. The Company has not recorded any liability for these guarantees and indemnities in the accompanying consolidated balance sheets. Product warranty costs are not significant.

9. Mindspeed Credit Facility

In connection with the Mindspeed Spin, the Company entered into a senior secured revolving credit facility pursuant to which Mindspeed may borrow up to \$50.0 million for working capital and general corporate purposes. Mindspeed may borrow under the credit facility only to restore its cash balance to \$25.0 million. Borrowings accrue interest at 10% per annum, payable at maturity, and are collateralized by substantially all the assets of Mindspeed. The credit facility expires on June 29, 2007. As of December 31, 2003, no amounts were outstanding under the credit facility.

In connection with the credit facility, Mindspeed issued to the Company warrants to purchase up to approximately 8.3 million shares of Mindspeed common stock. The number of shares that may be acquired under the warrants will depend on the level of borrowings under the credit facility, increasing pro rata as the principal balance of Mindspeed's borrowings increases. The warrants will be exercisable for a period of ten years after the Mindspeed Spin at a price per share equal to the fair market value of a share of Mindspeed common stock at the time of issuance of the warrants or at the time of the borrowing that entitles the Company to acquire shares thereunder, whichever is lower.

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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, 2003.

Overview

Except where otherwise noted, this discussion of our financial condition and results of operations represents our continuing operations, excluding our discontinued Mindspeed Technologies business which we spun off in June 2003. See Note 1 of Notes to Consolidated Condensed Financial Statements for further information on this transaction.

We design, develop and sell semiconductor system solutions for use in products driving broadband digital home information and entertainment applications. Our expertise in mixed-signal processing allows us to deliver semiconductor devices and integrated systems that connect the client, or end-customer, side of personal communications access products such as PCs, set-top boxes, residential gateways and game consoles to audio, video, voice and data services over broadband wireline communications networks, including asynchronous digital subscriber line (ADSL), cable and ethernet, over wireless local area networks and over direct broadcast satellite, terrestrial and fixed wireless systems. Our dial-up access products include a broad portfolio of modem chipsets and software for desktop and notebook PC applications as well as embedded equipment applications including fax machines, multifunction peripherals (MFPs), point-of-sale (POS) terminals, set-top boxes, gaming consoles and Internet terminals. Our media processing solutions include a variety of broadcast audio and video decoder and encoder devices that enable the capture, display, storage, playback and transfer of audio and video in digital home and small office environment products such as PCs, set-top boxes, gaming consoles, personal video recorders and digital versatile disk (DVD) applications. We operate in one business segment.

We market and sell our semiconductor products and system solutions directly to leading original equipment manufacturers (OEMs) of communication electronics products, and indirectly through electronic components distributors. We also sell our products to third-party electronic manufacturing service providers, who manufacture products incorporating our semiconductor products for OEMs. Sales to distributors accounted for approximately 44% of net revenues in the first three months of fiscal 2004. One customer (a foreign distributor) accounted for 14% of our net revenues in the first three months of fiscal 2004. No other customer accounted for 10% or more of our net revenues for the period. Our top 20 customers accounted for approximately 74% of net revenues for the first three months of fiscal 2004. Revenues derived from customers located in the Americas, Europe and the Asia-Pacific region were 13%, 8% and 79%, respectively, of our net revenues for the first three months of fiscal 2004. 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.

Pending Merger with GlobespanVirata, Inc.

On November 3, 2003, we entered into a definitive merger agreement with GlobespanVirata, Inc., a provider of broadband communications solutions for consumer, enterprise, personal computer and service provider markets. In the merger, GlobespanVirata shareholders will receive 1.198 shares of our common stock for each share of GlobespanVirata common stock. This transaction will be accounted for under the purchase method of accounting with Conexant as the acquiror for accounting purposes. The closing of this transaction is subject to shareholder approvals. Shareholders of both companies will vote on the proposed merger at their respective meetings to be held on February 25, 2004. We expect that the transaction will close promptly after obtaining such approvals.

Table of Contents**Results of Operations****Net Revenues**

We recognize revenues from product sales upon shipment and transfer of title, in accordance with the shipping terms specified in the arrangement with the customer. Revenue recognition is deferred in all instances where the earnings process is incomplete. We sell a portion of our products to electronic component distributors under agreements allowing for a right to return unsold products. We defer the recognition of revenue on all sales to these distributors until the products are sold by the distributors to a third party. We record a reserve for sales returns and allowances for other customers based on historical experience or specific identification of an event necessitating a reserve. Development revenue is recognized when services are performed and was not significant for any of the periods presented. The following table summarizes our net revenues:

| (in millions) | Three months ended | | | Change from Sept. 2003 Quarter | Change from Dec. 2002 Quarter |
|---------------|--------------------|-------------------|------------------|--|--|
| | Dec. 31, 2003 | Sept. 30, 2003 | Dec. 31, 2002 | | |
| Net revenues | \$ 177.3 | \$ 164.7 | \$ 144.2 | 8% | 23% |

Net revenues for the three months ended December 31, 2003 increased 23% over the comparable period in 2002. The increase primarily resulted from increased volume for our ADSL client-side modems, set-top box solutions, convergence video products using MPEG codec technology and embedded modem solutions. Soft modem revenues from products acquired from PCTEL in the third quarter of fiscal 2003 also contributed to the year over year growth.

Net revenues for the three months ended December 31, 2003 increased 8% sequentially from the previous quarter. This increase is primarily driven by increased volume of our ADSL client-side modems, set-top box solutions and PC video products.

Gross Margin

| (in millions) | Three months ended | | | Change from Sept. 2003 Quarter | Change from Dec. 2002 Quarter |
|----------------------------|--------------------|-------------------|------------------|---|--|
| | Dec. 31, 2003 | Sept. 30, 2003 | Dec. 31, 2002 | | |
| Gross margin | \$ 79.1 | \$ 72.1 | \$ 62.7 | 10% | 26% |
| Percent of net revenues | 45% | 44% | 44% | | |

Gross margin represents revenues less cost of goods sold. As a fabless semiconductor company, we use third parties for wafer production, assembly and test services. Our cost of goods sold consists predominantly of purchased finished wafers, assembly and test services, royalty and other intellectual property costs and labor and overhead associated with product procurement.

Our gross margin for the first quarter of fiscal 2004 of 45% compared with the similar period of fiscal 2003 of 44% reflects current quarter product cost reductions exceeding the decline in average selling prices (ASPs) as compared to the year ago period.

Our gross margin for the first quarter of fiscal 2003 benefited from the sale of inventories with an original cost of \$7.1 million that we had written down to a zero cost basis during fiscal year 2001. These sales resulted from renewed demand for certain products that was not anticipated at the time of the write-downs. The previously written-down inventories were generally sold at prices which exceeded their original cost. Had we not previously written down the cost basis of these goods, our cost of goods sold would include the original cost of such goods, and our gross margin for the first quarter of fiscal 2003 would have been \$55.6 million (39% of our net revenues). As of June 30, 2003, all such inventories had been scrapped or sold.

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When compared with the immediately preceding quarter, our gross margins for the first quarter of fiscal 2004 increased from 44% to 45% of net revenues. The improvement is attributable to a slightly improved product mix, and product cost reductions exceeding the decline in ASPs.

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We assess the recoverability of our inventories at least quarterly through a review of inventory levels in relation to foreseeable demand (generally over six months). Foreseeable demand is based upon all available information, including sales backlog and forecasts, product marketing plans and product life cycles. When the inventory on hand exceeds the foreseeable demand, we write down the value of those inventories which, at the time of our review, we expect to be unable to sell. The amount of the inventory write-down is the excess of historical cost over estimated realizable value. Once established, these write-downs are considered permanent adjustments to the cost basis of the excess inventory.

Our products are used by communications electronics OEMs that have designed our products into communications equipment. For many of our products, we gain these design wins through a lengthy sales cycle, which often includes providing technical support to the OEM customer. Moreover, once a customer has designed a particular supplier's components into a product, substituting another supplier's components often requires substantial design changes which involve significant cost, time, effort and risk. In the event of the loss of business from existing OEM customers, we may be unable to secure new customers for our existing products without first achieving new design wins. When the quantities of inventory on hand exceed foreseeable demand from existing OEM customers into whose products our products have been designed, we generally will be unable to sell our excess inventories to others, and the estimated realizable value of such inventories to us is generally zero.

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.

Under our long-term supply arrangement with Jazz Semiconductor, Inc. (Jazz), we are obligated to purchase certain minimum annual volumes of wafers through March 2005. Additionally, under a long-term supply agreement with Skyworks, we are obligated to purchase certain minimum amounts of assembly and test services during fiscal years 2004 and 2005. In the event our actual purchases under these arrangements are less than the required minimum volumes, we will be required to make additional payments, which would adversely affect our gross margin. We currently anticipate meeting each of the annual minimum purchase obligations under the long-term supply agreements with Jazz and Skyworks.

Research and Development

| (in millions) | Three months ended December 31, | | |
|--------------------------|---------------------------------|--------|--------|
| | 2003 | Change | 2002 |
| Research and development | \$39.2 | (3)% | \$40.2 |
| Percent of net revenues | 22% | | 28% |

Our research and development (R&D) expenses consist principally of direct personnel costs to develop new communications and semiconductor products, photomask and other 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 design automation and advanced package development. The decrease in R&D expenses for the first quarter of fiscal 2004 compared to the similar period of fiscal 2003 primarily reflects lower spending of materials for experimental lots and photomasks which were partially offset by additional headcount to support the expansion of new product development efforts in India and China.

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

| (in millions) | Three months ended December 31, | | |
|-------------------------------------|---------------------------------|--------|---------|
| | 2003 | Change | 2002 |
| Selling, general and administrative | \$ 22.8 | nm | \$ 22.8 |
| Percent of net revenues | 13% | | 16% |

nm= not meaningful

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. For the first quarter of fiscal 2004, SG&A expense stayed level with the same period of fiscal 2003 on a cost basis, but has decreased 3% as a percentage of net revenues. This reduction is attributable to an 18% decline in SG&A headcount associated with past restructuring activities offset by reductions in bad debt charges in the quarter ended December 31, 2002 associated with improving collections experience at that time.

Amortization of Intangible Assets

| (in millions) | Three months ended December 31, | | |
|-----------------------------------|---------------------------------|--------|--------|
| | 2003 | Change | 2002 |
| Amortization of intangible assets | \$ 1.0 | nm | \$ 0.8 |

nm= not meaningful

Amortization expense is recorded for intangible assets other than goodwill pursuant to SFAS 141 and 142. 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. Goodwill must be tested at least annually for impairment and written down when impaired.

The increased amortization expense in the first quarter of fiscal 2004 compared to the first quarter of fiscal 2003 is attributable to additional intangibles acquired in an acquisition in the latter half of fiscal 2003. We expect that amortization, exclusive of the impact of our pending merger with GlobespanVirata, of intangible assets will be approximately \$3.8 million for fiscal 2004.

Special Charges

Special charges consist of the following (in thousands):

| (in millions) | Three months ended December 31, | | |
|-----------------------|---------------------------------|--------|--------|
| | 2003 | Change | 2002 |
| Asset impairments | \$ 0.2 | nm | \$ 2.2 |
| Restructuring charges | 0.4 | nm | 1.9 |
| Other special charges | | nm | 2.7 |
| | \$ 0.6 | nm | \$ 6.8 |

nm= not meaningful

See Note 6 of Notes to Consolidated Condensed Financial Statements for a discussion of asset impairment charges, restructuring charges and special charges.

Table of Contents**Other Income, Net**

| (in millions) | Three months ended December 31, | | |
|-------------------|---------------------------------|--------|-------|
| | 2003 | Change | 2002 |
| Other income, net | \$25.3 | nm | \$3.4 |

nm= not meaningful

Other income, net for the first quarter of fiscal 2004 was comprised of a \$24.6 million increase in the fair value of the Mindspeed warrant, \$10.2 million of income in our equity method investments (including a \$11.4 million gain in accordance with Staff Accounting Bulletin No. 51 for the realization of an additional investment made by another party in Jazz Semiconductor) and \$2.5 million of investment and interest income on invested cash balances, offset by \$6.7 million of interest expense on our convertible subordinated notes and a \$4.9 million decrease in the fair value of the conversion right under the Skyworks 15% convertible senior subordinated notes. The \$11.4 million gain in our investment in Jazz Semiconductor is the result of our ownership in Jazz decreasing from 45% to approximately 38% when the additional favorable investment was realized. Due to variations in the fair values of the common stock underlying the Skyworks 15% convertible senior subordinated notes and the Mindspeed warrant, we expect that other income (expense) may fluctuate significantly in future periods until these derivative instruments are liquidated.

Other income, net for the first quarter of the previous year was comprised of a \$4.0 million increase in the fair value of the conversion right under the Skyworks 15% convertible senior subordinated notes, \$5.6 million of investment and interest income on invested cash balances, and \$1.3 million of income in our equity method investments offset by \$7.6 million of interest expense on our convertible subordinated notes.

The carrying values of non-marketable investments are at the lower of cost or their estimated fair values. These investments consist of equity interests in early stage technology companies which we had accounted for under the cost method. We estimate the fair value of these investments based upon available financial and other information, including the then-current and projected business prospects for the subject companies, and when we determine that the decline in the fair value of these investments is other than temporary, they are written down to their fair value.

Provision for Income Taxes

We recorded income tax expense of \$0.2 million and \$0.3 million for the three months ended December 31, 2003 and 2002, respectively, primarily reflecting taxes imposed on our foreign subsidiaries. No income tax expense was recorded with respect to the domestic results for the quarter as they will be offset by net operating loss carryovers that have not been previously recognized. We expect this will continue for the foreseeable future, and as result, we expect our income tax provision for fiscal 2004, exclusive of the impact of our pending merger with GlobespanVirata, to be approximately \$1.0 million consisting primarily of income taxes related to our foreign operations.

As of September 30, 2003, we had a valuation allowance of approximately \$413.0 million for the deferred tax assets that we do not expect to realize through the reduction of future income tax payments. We believe the remaining portion of our deferred tax assets will be realized based on our current expectations of future earnings and tax planning strategies available to us. We evaluate the realizability of our deferred tax assets quarterly and in the event that we determine that we will not be able to realize all or part of our deferred tax assets in the future, an adjustment to the deferred tax assets would be charged or credited to income in the period such determination is made.

Liquidity and Capital Resources

Our cash and cash equivalents increased by \$13.6 million during the first quarter of fiscal 2004. Cash provided by operating activities was \$22.3 million for the first quarter of fiscal 2004, compared to cash used in operating activities of \$14.1 million for the comparable period in fiscal 2003. Operating cash flows for the fiscal 2004 period reflect our income from continuing operations of \$40.6 million, offset by non-cash charges (depreciation and amortization and other) of \$6.1 million, a net increase in fair value of the Mindspeed warrant and the Skyworks note of \$19.7 million, a net increase in equity in earnings of equity method investees of \$10.2 million, and a net decrease in the components of working capital of \$5.4 million. The working capital decrease principally consists of a \$15.5 million increase in accounts payable and accrued expenses, offset by a \$6.1 million increase in accounts receivable, both attributable to the growth in our business. Net inventories have decreased by \$0.6 million.

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Cash used by investing activities of \$14.8 million for the first quarter of fiscal 2004 includes capital expenditures of \$4.9 million, net purchases of marketable securities of \$4.3 million, payment of deferred purchase consideration of \$4.0 million, payment of deferred merger costs of \$1.4 million and investments of \$0.5 million. Cash provided by investing activities of \$121.6 million in the first quarter of fiscal 2003 principally consisted of the repayment of the Skyworks note (net of the credit facility of \$135.0 million), \$1.0 million in proceeds from the sale of assets, partially offset by \$9.7 million of net purchases of marketable securities, capital expenditures of \$3.2 million and payments for investments of \$1.5 million.

Cash provided by financing activities of \$6.1 million and \$0.7 million for the first quarter of fiscal 2004 and 2003, respectively, consisted of proceeds from the exercise of stock options.

At December 31, 2003, we held \$45.0 million principal amount of the Skyworks 15% convertible senior subordinated notes with a maturity date of June 30, 2005. Skyworks may redeem the 15% convertible senior subordinated notes at any time after May 12, 2004, subject to a redemption premium of 3% of the outstanding principal amount. We may, at our option, convert the outstanding principal amount of the 15% convertible senior subordinated notes into shares of Skyworks common stock based upon the conversion price (initially \$7.87 per share, subject to adjustment under certain circumstances). At maturity, Skyworks must pay the outstanding principal amount by delivering to us a number of shares of its common stock based upon the conversion price. Skyworks has granted us certain registration rights relating to the 15% convertible senior subordinated notes and the shares of Skyworks common stock underlying the 15% convertible senior subordinated notes. As of December 31, 2003 the estimated fair value of the 15% convertible senior subordinated notes was approximately \$51.0 million. We have the ability and intent to sell all or part of the 15% convertible senior subordinated notes or shares underlying the notes within the next twelve months.

As of December 31, 2003, our principal sources of liquidity are our existing cash reserves and short-term investments (including the Skyworks 15% convertible senior subordinated notes), the current portion of the Mindspeed warrant and cash generated from product sales. Combined cash and cash equivalents, short-term investments and Skyworks 15% convertible senior subordinated notes at December 31, 2003 totaled \$188.3 million compared to \$175.5 million at September 30, 2003. The current portion of the Mindspeed warrant at December 31, 2003 was \$21.4 million. Our working capital at December 31, 2003 was \$262.5 million compared to \$233.0 million at September 30, 2003.

In connection with the Mindspeed Spin in June 2003, we entered into a senior secured revolving credit facility with Mindspeed, pursuant to which Mindspeed may borrow up to \$50.0 million from us for working capital and general corporate purposes. Mindspeed may borrow under the credit facility only to restore its cash balance to \$25.0 million. The credit facility is available through June 29, 2007 and as of December 31, 2003, no amounts were outstanding.

We believe that our existing sources of liquidity, along with cash expected to be generated from product sales, will be sufficient to fund our operations, research and development efforts, anticipated capital expenditures, remaining accrued restructuring balance of \$10.3 million, and other capital requirements, including our commitment under the credit facility with Mindspeed, and amounts anticipated to complete our pending merger with GlobespanVirata, for at least the next twelve months. We will need to continue a focused program of capital expenditures to meet our research and development and corporate requirements. We may also consider acquisition opportunities to extend our technology portfolio and design expertise and to expand our product offerings. In order to fund capital expenditures, increase our working capital or complete any acquisitions, we may 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.

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Off-Balance Sheet Arrangements

Our off-balance arrangements consist of conventional operating leases, capital commitments and purchase commitments as described under Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations - Off-Balance Sheet Arrangements on pages 33 and 34 of our Annual Report on Form 10-K for the fiscal year ended September 30, 2003. Management believes that at December 31, 2003, there has been no material change to this information. We do not have any special purpose entities or variable interest entities as of December 31, 2003.

See Note 9 of Notes to Consolidated Condensed Financial Statements for a description of our commitment with respect to the Mindspeed senior secured revolving credit facility.

In addition, at December 31, 2003 we were contingently liable for approximately \$33.4 million in operating lease commitments on facility leases that were assigned to Mindspeed and Skyworks at the time of their separation from Conexant.

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 consolidated financial statements are those relating to allowances for doubtful accounts, inventories, long-lived assets, income taxes, valuation of derivative instruments, restructuring costs, long-term employee benefit plans 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. Detailed information on these critical accounting policies is included under Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations - Critical Accounting Policies on pages 34 to 36 of our Annual Report on Form 10-K for the fiscal year ended September 30, 2003. Management believes that at December 31, 2003, there has been no material change to this information.

Certain Business Risks

Our business, financial condition and operating results can be impacted by a number of factors, any one of which could cause our actual results to vary materially from recent results or from our anticipated future results. Any of these risks could 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.

Detailed information on these risk factors is included under Item 1. Business - Certain Business Risks on pages 10 to 18 of our Annual Report on Form 10-K for the fiscal year ended September 30, 2003. Management believes that at December 31, 2003, there has been no material change to this information.

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

Our financial instruments include cash and cash equivalents, marketable debt securities, the Skyworks 15% convertible senior subordinated notes, the Mindspeed warrant, equity securities and our 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.

Our cash and cash equivalents are not subject to significant interest rate risk due to the short maturities of these instruments. As of December 31, 2003, 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. Marketable equity securities are subject to equity price risk. As of December 31, 2003, a 10% adverse change in equity prices would result in a \$0.5 million decrease in the value of our marketable equity securities.

We hold Skyworks 15% convertible senior subordinated notes having an aggregate principal amount of \$45.0 million. The conversion right is considered an embedded derivative for financial accounting purposes and the value of the Skyworks 15% convertible senior subordinated notes is subject to significant risk related to changes in the market price of Skyworks common stock. As of December 31, 2003, a 10% decrease in the market price of Skyworks common stock would decrease the fair value of the Skyworks 15% convertible senior subordinated notes by approximately \$5.2 million. The Skyworks 15% convertible senior subordinated notes are also subject to interest rate risk. At December 31, 2003, the market price of Skyworks common stock was \$9.00 per share. For the quarter ended December 31, 2003, the market price of Skyworks common stock ranged from a low of \$7.58 per share to a high of \$11.21 per share.

We received the 15% convertible senior subordinated notes from Skyworks in exchange for the remaining \$45.0 million principal amount of the Term Notes (originally delivered to us by Skyworks in payment of the purchase price for our Mexicali assembly and test facility). We do not purchase derivative financial instruments for speculative or investment purposes.

We hold a warrant to purchase 30 million shares of common stock of Mindspeed. For financial accounting purposes, this is a derivative instrument and the fair value of the warrant is subject to significant risk related to changes in the market price of Mindspeed's common stock. As of December 31, 2003, a 10% decrease in the market price of Mindspeed's common stock would decrease the fair value of this warrant by approximately \$19.8 million. At December 31, 2003, the market price of Mindspeed's common stock was \$6.89 per share. For the quarter ended December 31, 2003, the market price of Mindspeed's common stock ranged from a low of \$5.02 per share to a high of \$7.11 per share.

We classify all of our marketable debt and equity securities as available-for-sale securities. As of December 31, 2003, the carrying value of these securities included net unrealized gain of \$2.6 million.

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 financial instruments as of December 31, 2003:

| (in millions) | Carrying Value | Fair Value |
|--|-------------------|------------|
| Cash and cash equivalents | \$ 89.8 | \$ 89.8 |
| Marketable debt securities | 22.0 | 22.0 |
| Marketable government securities | 20.5 | 20.5 |
| Skyworks 15% convertible senior subordinated notes | 51.0 | 51.0 |
| Marketable equity securities | 5.0 | 5.0 |
| Mindspeed warrant | 143.9 | 143.9 |
| Long-term debt | 581.8 | 561.7 |

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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. 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 December 31, 2003, we held no foreign currency forward exchange contracts. Based on our overall currency rate exposure at December 31, 2003, a 10 percent change in the currency rates would not have a material effect on our consolidated financial position, results of operations or cash flows.

ITEM 4. CONTROLS AND PROCEDURES

An evaluation as of the end of the period covered by this report was carried out under the supervision and with the participation of the Company's management, including the Company's Chairman and Chief Executive Officer and its Senior Vice President and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures, which are defined under Securities and Exchange Commission rules as controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files under the Exchange Act is recorded, processed, summarized and reported within required time periods. Based upon that evaluation, the Company's Chairman and Chief Executive Officer and its Senior Vice President and Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective.

There were no changes in the Company's internal control over financial reporting during the quarter ended December 31, 2003 that have materially affected, or are reasonably likely to materially effect, the Company's internal control over financial reporting.

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PART II. OTHER INFORMATION

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits:

2 Agreement and Plan of Reorganization dated as of November 3, 2003, as amended as of January 15, 2004, by and among the Company, Concentric Sub, Inc. and GlobespanVirata, Inc., included as Annex A to the Company's Registration Statement on Form S-4 (Registration No. 333-111179), is incorporated herein by reference.

31.1 Certification of the Chief Executive Officer of Periodic Report Pursuant to Rule 13a -15(e) or 15d-15(e).

31.2 Certification of the Chief Financial Officer of Periodic Report Pursuant to Rule 13a -15(e) or 15d-15(e).

32 Certification by Chief Executive Officer and Chief Financial Officer of Periodic Report Pursuant to 18 U.S.C. Section 1350.

(b) Reports on Form 8-K

Current Report on Form 8-K dated October 31, 2003, furnishing the Company's press release dated October 30, 2003, announcing its financial results for the fourth quarter and year ended September 30, 2003 (Item 12).

Current Report on Form 8-K dated November 3, 2003, announcing the signing of a definitive merger agreement with GlobespanVirata, Inc. (Items 5 and 7).

Current Report on Form 8-K dated November 4, 2003, filing the definitive merger agreement with GlobespanVirata, Inc. (Items 5 and 7).

Current Report on Form 8-K dated January 28, 2004, furnishing the Company's press release dated January 28, 2004, announcing its financial results for the first quarter ended December 31, 2003 (Item 12).

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SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

CONEXANT SYSTEMS, INC.
(Registrant)

Date: February 5, 2004

By /s/ J. Scott Blouin

J. Scott Blouin
Senior Vice President and
Chief Financial Officer
(principal financial officer)

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EXHIBIT INDEX

- 31.1 Certification of the Chief Executive Officer of Periodic Report Pursuant to Rule 13a -15(e) or 15d-15(e).
- 31.2 Certification of the Chief Financial Officer of Periodic Report Pursuant to Rule 13a -15(e) or 15d-15(e).
- 32 Certification by Chief Executive Officer and Chief Financial Officer of Periodic Report Pursuant to 18 U.S.C. Section 1350.

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