

MINDSPEED TECHNOLOGIES, INC

Form 10-Q

August 08, 2006

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

**FORM 10-Q**

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

**For the quarterly period ended June 30, 2006  
OR**

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

**Commission file number: 000-50499  
MINDSPEED TECHNOLOGIES, INC.  
(Exact name of registrant as specified in its charter)**

**Delaware**  
(State of incorporation)

**01-0616769**  
(I.R.S. Employer Identification No.)

**4000 MacArthur Boulevard, East Tower  
Newport Beach, California 92660-3095  
(Address of principal executive offices) (Zip code)  
(949) 579-3000**

(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

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

Indicate by check mark whether the registrant is a shell company (as defined by Rule 12b-2 of the Exchange Act).

Yes  No

Number of shares of the registrant's common stock outstanding as of July 28, 2006 was 110,465,226.

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**FORWARD-LOOKING STATEMENTS**

This Quarterly Report on Form 10-Q contains statements relating to Mindspeed Technologies, 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 (the Securities Act), and Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act), and are subject to the safe harbor created by those sections. All statements included in this Quarterly Report on Form 10-Q, other than those that are purely historical, are forward-looking statements. Words such as expect, believe, anticipate, outlook, could, target, project, intend, plan, seek, estimate, and continue, as well as variations of such words and similar expressions, also identify forward-looking statements.

Forward-looking statements in this Quarterly Report on Form 10-Q include, without limitation, statements regarding:

the ability of our relationships with network infrastructure original equipment manufacturers to facilitate early adoption of our products, enhance our ability to obtain design wins and encourage adoption of our technology in the industry;

the growth prospects for the network infrastructure equipment and communications semiconductors markets, including increased demand for network capacity, the upgrade and expansion of legacy networks and the build-out of networks in developing countries;

our investment in research and development and participation in the formulation of industry standards;

the focus of our research and development efforts on products addressing voice-over-Internet protocol and high-performance analog applications and our expectation of the growth prospects for those products;

our ability to achieve design wins and convert wins into revenue;

the availability of raw materials, parts and supplies;

the continuation of intense price and product competition, and the resulting declining average selling prices for our products;

the impact of changes in customer purchasing activities, inventory levels and inventory management practices;

our ability to achieve revenue growth and profitability, or to achieve positive cash flows from operations, and the expected period through which we will continue to incur significant losses and negative cash flows;

our plans to reduce operating expenses, and the amount and timing of any such expense reductions;

the dependence of our operating results on our ability to introduce products on a timely basis;

the sufficiency of our existing sources of liquidity and expected sources of cash to fund our operations, research and development efforts, anticipated capital expenditures, working capital and other financing requirements for the next twelve months;

the expected cost savings under our restructuring plans and the uses of those savings, as well as the amounts of future charges to complete the restructuring plans;

our expectation of paying our obligations relating to our restructuring plans and other obligations over their respective terms, our intention to fund those payments from available cash balances and funds from product sales and the impact of such payments on our liquidity;

the circumstances under which we may need to seek additional financing, our ability to obtain any such financing and any consideration of acquisition opportunities;

our expectations with respect to our recognition of income tax benefits in the future;

our plans relating to our use of stock-based compensation, the effectiveness of our incentive compensation programs and other compensation arrangements and the expected amounts of stock-based compensation expense in future periods;

our intentions with respect to inventories that were previously written down;

our beliefs regarding the effect of the disposition of pending or asserted legal matters;

the amount and timing of future payments under contractual obligations; and

the impact of recent accounting pronouncements and the adoption of new accounting standards.

Our expectations, beliefs, anticipations, objectives, intentions, plans and strategies regarding the future are not guarantees of future performance and are subject to risks and uncertainties that could cause actual results, and actual events that occur, to differ materially from results contemplated by the forward-looking statement. These risks and uncertainties include, but are not limited to:

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market demand for our new and existing products, and our ability to increase our revenues;

our ability to maintain operating expenses within anticipated levels;

our ability to reduce our cash consumption;

constraints in the supply of wafers and other product components from our third-party manufacturers;

availability and terms of capital needed for our business;

the ability to attract and retain qualified personnel;

successful development and introduction of new products;

our ability to obtain design wins and develop revenues from them;

pricing pressures and other competitive factors;

order and shipment uncertainty;

changes in our customers' inventory levels and inventory management practices;

fluctuations in manufacturing yields;

product defects; and

intellectual property infringement claims by others and the ability to protect our intellectual property.

The forward-looking statements in this report are subject to additional risks and uncertainties, including those set forth in Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations under the heading Risk Factors and those detailed from time to time in our other filings with the Securities and Exchange Commission. These forward-looking statements are made only as of the date hereof and, except as required by law, we undertake no obligation to update or revise any of them, whether as a result of new information, future events or otherwise.

Mindspeed® and Mindspeed Technologies® are registered trademarks of Mindspeed Technologies, Inc. Other brands, names and trademarks contained in this report are the property of their respective owners.

For presentation purposes of this Quarterly Report on Form 10-Q, references made to the periods ended June 30, 2006 and 2005 relate to the actual fiscal 2006 third quarter ended June 30, 2006 and the actual fiscal 2005 third quarter ended July 1, 2005, respectively.

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

	<b>June 30, 2006</b>	<b>September 30, 2005</b>
<b>ASSETS</b>		
<b>Current Assets</b>		
Cash and cash equivalents	\$ 20,395	\$ 15,335
Marketable securities	23,705	40,094
Receivables, net of allowance for doubtful accounts of \$466 and \$462 at June 30, 2006 and September 30, 2005, respectively	17,495	16,356
Inventories, net	20,261	10,730
Other current assets	2,689	3,389
Total current assets	84,545	85,904
Property, plant and equipment, net	12,693	14,890
Other assets	4,539	4,710
Total assets	\$ 101,777	\$ 105,504
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
<b>Current Liabilities</b>		
Accounts payable	\$ 11,291	\$ 9,776
Deferred revenue	4,371	3,452
Accrued compensation and benefits	6,127	6,722
Restructuring	2,163	3,442
Other current liabilities	4,208	3,180
Total current liabilities	28,160	26,572
Convertible senior notes	44,517	44,219
Other liabilities	846	887
Total liabilities	73,523	71,678
Commitments and contingencies		
<b>Stockholders Equity</b>		
Preferred stock, \$0.01 par value: 25,000 shares authorized; no shares issued or outstanding	1,104	1,039

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Common stock, \$0.01 par value: 500,000 shares authorized; 110,380 and 103,852 shares issued at June 30, 2006 and September 30, 2005, respectively

Additional paid-in capital	248,358	237,003
Accumulated deficit	(205,214)	(188,052)
Accumulated other comprehensive loss	(15,994)	(16,164)
Total stockholders' equity	28,254	33,826
Total liabilities and stockholders' equity	\$ 101,777	\$ 105,504

See accompanying notes to consolidated condensed financial statements.



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

	Three months ended		Nine months ended	
	June 30,		June 30,	
	2006	2005	2006	2005
Net revenues	\$ 35,894	\$ 27,738	\$ 103,707	\$ 80,698
Cost of goods sold (1)	11,195	8,207	31,898	24,505
Gross margin	24,699	19,531	71,809	56,193
Operating expenses:				
Research and development (1)	15,049	16,748	48,596	54,965
Selling, general and administrative (1)	11,807	10,797	35,305	31,889
Amortization of intangible assets		824		20,481
Special charges (1)	1,053	(125)	2,234	5,856
Total operating expenses	27,909	28,244	86,135	113,191
Operating loss	(3,210)	(8,713)	(14,326)	(56,998)
Interest expense	(569)	(553)	(1,673)	(1,238)
Other income, net	178	360	906	791
Loss before income taxes	(3,601)	(8,906)	(15,093)	(57,445)
Provision for income taxes	943	561	2,069	896
Net loss	\$ (4,544)	\$ (9,467)	\$ (17,162)	\$ (58,341)
Net loss per share, basic and diluted	\$ (0.04)	\$ (0.09)	\$ (0.16)	\$ (0.57)
Weighted-average number of shares used in per share computation	106,510	102,698	105,069	101,859
(1) Includes stock-based compensation expense as follows:				
Cost of goods sold	\$ 110	\$ 3	\$ 285	\$ 8
Research and development	785	93	2,083	178
Selling, general and administrative	1,335	40	2,851	114
Special charges	199		373	

Total stock-based compensation expense	\$	2,429	\$	136	\$	5,592	\$	300
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See accompanying notes to consolidated condensed financial statements.

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**MINDSPEED TECHNOLOGIES, INC.**  
**Consolidated Condensed Statements of Cash Flows**  
**(unaudited, in thousands)**

	Nine months ended June 30,	
	2006	2005
<b>Cash Flows From Operating Activities</b>		
Net loss	\$ (17,162)	\$ (58,341)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation	5,241	7,072
Amortization of intangible assets		20,481
Stock-based compensation	5,592	300
Asset impairments		604
Inventory provisions	(612)	977
Other non-cash items, net	341	428
Changes in assets and liabilities:		
Receivables	(1,143)	5,000
Inventories	(8,919)	948
Accounts payable	1,519	(785)
Deferred revenue	919	(113)
Accrued expenses and other current liabilities	(179)	173
Other	42	412
 Net cash used in operating activities	 (14,361)	 (22,844)
 <b>Cash Flows From Investing Activities</b>		
Capital expenditures	(2,999)	(3,232)
Sales of assets		149
Purchases of available-for-sale marketable securities	(33,597)	(61,725)
Sales of available-for-sale marketable securities	49,135	20,950
Purchases of held-to-maturity marketable securities		(3,253)
Maturities of held-to-maturity marketable securities	1,725	767
 Net cash provided by (used in) investing activities	 14,264	 (46,344)
 <b>Cash Flows From Financing Activities</b>		
Sale of convertible senior notes		43,930
Exercise of stock options and warrants	5,157	2,915
Deferred financing costs		(433)
 Net cash provided by financing activities	 5,157	 46,412

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Net increase (decrease) in cash and cash equivalents	5,060	(22,776)
Cash and cash equivalents at beginning of period	15,335	43,638
Cash and cash equivalents at end of period	\$ 20,395	\$ 20,862

See accompanying notes to consolidated condensed financial statements.

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**MINDSPEED TECHNOLOGIES, INC.**  
**NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS**  
(unaudited)

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

Mindspeed Technologies, Inc. (Mindspeed or the Company) designs, develops and sells semiconductor networking solutions for communications applications in enterprise, access, metropolitan and wide-area networks. On June 27, 2003, Conexant Systems, Inc. (Conexant) completed the distribution (the Distribution) to Conexant stockholders of all 90,333,445 outstanding shares of common stock of its wholly owned subsidiary, Mindspeed. In the Distribution, each Conexant stockholder received one share of Mindspeed common stock, par value \$.01 per share (including an associated preferred share purchase right) for every three shares of Conexant common stock held and cash for any fractional share of Mindspeed common stock. Following the Distribution, Mindspeed began operations as an independent, publicly held company.

Prior to the Distribution, Conexant transferred to Mindspeed the assets and liabilities of the Mindspeed business, including the stock of certain subsidiaries, and certain other assets and liabilities which were allocated to Mindspeed under the Distribution Agreement entered into between Conexant and Mindspeed. Also prior to the Distribution, Conexant contributed to Mindspeed cash in an amount such that at the time of the Distribution Mindspeed's cash balance was \$100 million. Mindspeed issued to Conexant a warrant to purchase 30 million shares of Mindspeed common stock at a price of \$3.408 per share, exercisable for a period beginning one year and ending ten years after the Distribution. In connection with the Distribution, Mindspeed and Conexant also entered into a Credit Agreement, an Employee Matters Agreement, a Tax Allocation Agreement, a Transition Services Agreement and a Sublease.

*Basis of Presentation* The consolidated condensed financial statements, prepared in accordance with accounting principles generally accepted in the United States of America, include the accounts of Mindspeed and each of its subsidiaries. All accounts and transactions among Mindspeed and its subsidiaries have been eliminated in consolidation. In the opinion of management, the accompanying consolidated condensed financial statements contain all adjustments, consisting of adjustments of a normal recurring nature and the special charges (Note 6), 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 financial 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, 2005.

*Fiscal Periods* For presentation purposes, references made to the periods ended June 30, 2006 and 2005 relate to the actual fiscal 2006 third quarter ended June 30, 2006 and the actual fiscal 2005 third quarter ended July 1, 2005, respectively.

*Recent Accounting Standards* The Company adopted Statement of Financial Accounting Standards (SFAS) No. 151, Inventory Costs, an amendment of Accounting Research Bulletin (ARB) No. 43, Chapter 4 as of the beginning of fiscal 2006, with no material effect on its financial condition or results of operations.

In May 2005, the Financial Accounting Standards Board issued SFAS No. 154, Accounting Changes and Error Corrections, which replaces Accounting Principles Board (APB) Opinion No. 20, Accounting Changes, and SFAS No. 3, Reporting Accounting Changes in Interim Financial Statements. SFAS No. 154 applies to all voluntary changes in accounting principle and requires retrospective application (a term defined by the statement) to prior periods financial statements, unless it is impracticable to determine the effect of a change. It also applies to changes required by an accounting pronouncement that does not include specific transition provisions. SFAS 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The Company will adopt SFAS No. 154 as of the beginning of fiscal 2007, and does not expect that the adoption of SFAS 154 will have a material impact on its financial condition or results of operations.

In July 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48) which clarifies the accounting for uncertainty in income taxes recognized in the financial statements in accordance with FASB Statement No. 109, Accounting for Income Taxes. This pronouncement recommends a recognition threshold and measurement process for recording in the financial statements uncertain tax positions taken or expected to be taken in the Company's tax return. FIN 48 also provides guidance on derecognition,



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**MINDSPEED TECHNOLOGIES, INC.**  
**NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (continued)**  
(unaudited)

classification, interest and penalties, accounting in interim periods and disclosure requirements for uncertain tax positions. The accounting provisions of FIN 48 will be effective for the Company beginning January 1, 2007. The Company is in the process of evaluating the effect, if any, the adoption of FIN 48 will have on its financial statements.

*Income Taxes* The provision for income taxes for the nine months ended June 30, 2006 and 2005 principally consists of income taxes incurred by the Company's foreign subsidiaries.

*Supplemental Cash Flow Information* Interest paid for the nine months ended June 30, 2006 and 2005 was \$1.7 million and \$767,000, respectively. Income taxes paid, net of refunds received, for the nine months ended June 30, 2006 and 2005 were \$(69,000) and \$332,000, respectively.

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

**2. Supplemental Financial Statement Data*****Marketable Securities***

Marketable securities principally consist of auction rate debt securities and auction rate preferred securities with interest at rates that are reset periodically (generally every seven or twenty-eight days). These securities are classified as available-for-sale securities and recorded at fair value in the accompanying balance sheets. Any unrealized gains/losses are included in other comprehensive income, unless a loss is determined to be other than temporary. As of June 30, 2006, the securities have a fair value of approximately \$22.9 million and there are no unrealized gains or losses. The Company classifies available-for-sale securities as current assets in the accompanying balance sheets because the Company has the ability and intent to sell these securities as necessary to meet its liquidity requirements. Marketable securities also include U.S. Treasury securities having an aggregate face amount of \$863,000 purchased in connection with the sale of \$46.0 million aggregate principal amount of Convertible Senior Notes. These securities, which mature in November 2006, were pledged to the trustee for the payment of the first four scheduled interest payments on the notes when due. Consequently, these securities are classified as held-to-maturity securities and are recorded at their amortized cost of \$855,000, which approximates fair value.

***Inventories***

Inventories consist of the following (in thousands):

	<b>June 30, 2006</b>	<b>September 30, 2005</b>
Work-in-process	\$ 10,555	\$ 5,422
Finished goods	9,706	5,308
	<b>\$ 20,261</b>	<b>\$ 10,730</b>

During the nine months ended June 30, 2006 and 2005, the Company sold inventories with an original cost of approximately \$3.9 million and \$7.2 million, respectively, that had been written down to a zero cost basis during fiscal 2001.

***Comprehensive Loss***

Comprehensive loss is as follows (in thousands):

	<b>Three months ended June 30,</b>		<b>Nine months ended June 30,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
Net loss	\$ (4,544)	\$ (9,467)	\$ (17,162)	\$ (58,341)
Foreign currency translation adjustments	269	(143)	170	(73)

Comprehensive loss	\$ (4,275)	\$ (9,610)	\$ (16,992)	\$ (58,414)
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The balance of accumulated other comprehensive loss at June 30, 2006 and September 30, 2005 consists of accumulated foreign currency translation adjustments.

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**MINDSPEED TECHNOLOGIES, INC.**  
**NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (continued)**  
(unaudited)

**Revenues by Product Line**

Revenues by product line are as follows (in thousands):

	<b>Three months ended</b>		<b>Nine months ended</b>	
	<b>June 30,</b>		<b>June 30,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
Multiservice access DSP products	\$ 8,896	\$ 8,974	\$ 28,733	\$ 24,188
High-performance analog products	11,925	6,854	31,935	20,028
WAN communications products	15,073	11,910	43,039	36,482
	\$ 35,894	\$ 27,738	\$ 103,707	\$ 80,698

**Revenues by Geographic Area**

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

	<b>Three months ended</b>		<b>Nine months ended</b>	
	<b>June 30,</b>		<b>June 30,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
Americas	\$ 11,557	\$ 8,314	\$ 36,447	\$ 29,704
Asia-Pacific	18,396	16,025	54,852	41,124
Europe, Middle East and Africa	5,941	3,399	12,408	9,870
	\$ 35,894	\$ 27,738	\$ 103,707	\$ 80,698

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.

During the nine months ended June 30, 2006 and 2005, the following direct customers accounted for 10% or more of net revenues:

	<b>Nine months ended</b>	
	<b>June 30,</b>	
	<b>2006</b>	<b>2005</b>
Customer A	17%	15%
Customer B	11%	14%
Customer C	9%	16%
Customer D	8%	12%

**3. Stock Warrants**

During the nine months ended June 30, 2005, the Company issued 478,405 shares of its common stock upon the exercise of all remaining warrants held by Jazz Semiconductor, Inc. for aggregate proceeds of \$1.2 million.

As of June 30, 2006, outstanding warrants consist of a warrant to purchase 30 million shares of Mindspeed common stock at a price of \$3.408 per share, exercisable through June 27, 2013, held by Conexant.

**4. Stock-Based Compensation**

Effective October 1, 2005, the Company adopted SFAS No. 123 (revised 2004), Share-Based Payment (SFAS 123R). SFAS 123R requires that the Company account for all stock-based compensation using a fair-value method and recognize the fair value of each award as an expense over the service period. For fiscal 2005 and earlier years, the

Company accounted for stock-based compensation using the intrinsic value method of APB Opinion No. 25

Accounting for Stock Issued to Employees and related interpretations and followed the disclosure requirements of SFAS No. 123, Accounting for Stock-Based Compensation, as amended by SFAS 148 Accounting for Stock-Based Compensation Transition and Disclosure. Under the intrinsic value method required by APB 25, the Company generally recognized no compensation expense with respect to stock option awards or awards under the employee stock purchase plan.

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**MINDSPEED TECHNOLOGIES, INC.**  
**NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (continued)**  
(unaudited)

The Company elected to adopt SFAS 123R using modified prospective application. Under that method, compensation expense includes the fair value of new awards, modified awards and any unvested awards outstanding at October 1, 2005. However, the consolidated financial statements for periods prior to the adoption of SFAS 123R have not been restated to reflect the fair value method of accounting for stock-based compensation. Stock-based compensation expense for fiscal 2005 and earlier years represents the cost of restricted stock awards determined in accordance with APB 25.

Stock-based compensation awards generally vest over time and require continued service to the Company and, in some cases, require the achievement of specified performance conditions. The amount of compensation expense recognized is based upon the number of awards that are ultimately expected to vest. The Company estimates forfeiture rates of 8.5% to 10% depending on the characteristics of the award.

As a result of the Company's recent operating losses and its expectation of future operating results, no income tax benefits have been recognized for any U.S. federal and state operating losses including those related to stock-based compensation expense. The Company does not expect to recognize any income tax benefits relating to future operating losses until it determines that such tax benefits are more likely than not to be realized.

The fair value of stock options awarded during the nine months ended June 30, 2006 was estimated at the date of grant using the Black-Scholes option-pricing model. The following table summarizes the weighted-average assumptions used and the resulting fair value of options granted:

	<b>Nine months ended June 30, 2006</b>
Weighted-average fair value of options granted	\$ 1.77
<b>Weighted-average assumptions:</b>	
Expected option term	3.4 years
Risk-free interest rate	4.6%
Expected volatility	77%
Dividend yield	

The expected option term was estimated based upon historical experience and management's expectation of exercise behavior. The expected volatility of the Company's stock price is based upon the historical daily changes in the price of the Company's common stock. The risk-free interest rate is based upon the current yield on U.S. Treasury securities having a term similar to the expected option term. Dividend yield is estimated at zero because the Company does not anticipate paying dividends in the foreseeable future.

The following table illustrates the effect on net loss and net loss per share for the three months and nine months ended June 30, 2005, as if compensation expense for all awards of stock-based employee compensation had been determined under the fair value-based method prescribed by SFAS 123 (in thousands, except per share amounts):

	<b>Three months ended June 30, 2005</b>	<b>Nine months ended June 30, 2005</b>
Net loss, as reported	\$ (9,467)	\$ (58,341)
Stock-based employee compensation expense included in the determination of reported net loss	136	300

Stock-based employee compensation expense determined under the fair value method	(1,770)	(9,006)
Pro forma net loss	\$ (11,101)	\$ (67,047)
Net loss per share, basic and diluted:		
As reported	\$ (0.09)	\$ (0.57)
Pro forma	\$ (0.11)	\$ (0.66)

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**MINDSPEED TECHNOLOGIES, INC.**  
**NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (continued)**  
(unaudited)

The fair value of stock options awarded during the nine months ended June 30, 2005 was estimated at the date of grant using the Black-Scholes option-pricing model. The following table summarizes the weighted-average assumptions used and the resulting fair value of options granted:

	<b>Nine months ended June 30, 2005</b>
Weighted-average fair value of options granted	\$ 1.05
Weighted-average assumptions:	
Expected option term	2.1 years
Risk-free interest rate	3.9%
Expected volatility	80%
Dividend yield	

*Stock Compensation Plans*

The Company has two principal stock incentive plans: the 2003 Long-Term Incentives Plan and the Directors Stock Plan. The 2003 Long-Term Incentives Plan provides for the grant of stock options, restricted stock and other stock-based awards to officers and employees of the Company. The Directors Stock Plan provides for the grant of stock options, restricted stock and other stock-based awards to the Company's non-employee directors. As of June 30, 2006, an aggregate of 5.8 million shares of the Company's common stock are available for issuance under these plans. In addition, the Directors Stock Plan provides that the number of shares available for issuance is automatically increased on the first day of each fiscal year by an amount equal to the greater of 160,000 shares or 0.18% of the shares of the Company's common stock outstanding on that date, subject to the board being authorized and empowered to select a smaller amount.

The Company also has a 2003 Stock Option Plan, under which stock options were issued in connection with the Distribution. In the Distribution, each holder of a Conexant stock option (other than options held by persons in certain foreign locations) received an option to purchase a number of shares of Mindspeed common stock. The number of shares subject to, and the exercise prices of, the outstanding Conexant options and the Mindspeed options were adjusted so that the aggregate intrinsic value of the options was equal to the intrinsic value of the Conexant option immediately prior to the Distribution and the ratio of the exercise price per share to the market value per share of each option was the same immediately before and after the Distribution. As a result of such option adjustments, Mindspeed issued options to purchase an aggregate of approximately 29.9 million shares of its common stock to holders of Conexant stock options (including Mindspeed employees) under the 2003 Stock Option Plan. There are no shares available for new stock option awards under the 2003 Stock Option Plan. However, any shares subject to the unexercised portion of any terminated, forfeited or cancelled option are available for future option grants only in connection with an offer to exchange outstanding options for new options.

The Company also maintains employee stock purchase plans for its domestic and foreign employees, under which 1.4 million shares are available for issuance. The employee stock purchase plans provide that the maximum number of shares under the plans is automatically increased on the first day of each fiscal year by an aggregate of 750,000 shares.

*Stock Option Awards*

Prior to fiscal 2006, stock-based compensation consisted principally of stock options. Eligible employees received grants of stock options at the time of hire; the Company also made broad-based stock option grants covering substantially all employees annually. Stock option awards have exercise prices not less than the market price of the common stock at the grant date and a contractual term of eight or ten years, and are subject to time-based vesting (generally over four years). The following table summarizes stock option activity under all plans (shares in thousands):



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**MINDSPEED TECHNOLOGIES, INC.**  
**NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (continued)**  
(unaudited)

	Number of Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term
Outstanding at September 30, 2005	26,080	\$ 2.30	
Granted	734	\$ 3.12	
Exercised	(2,903)	\$ 1.78	
Forfeited or expired	(1,365)	\$ 3.43	
Outstanding at June 30, 2006	22,546	\$ 2.33	4.5 years
Exercisable at end of period	18,267	\$ 2.25	4.2 years

As of June 30, 2006, there was unrecognized compensation expense of \$2.3 million related to unvested stock options, which the Company expects to recognize over a weighted-average period of 2.1 years. The aggregate intrinsic value of options exercised during the nine months ended June 30, 2006 was \$4.4 million. The aggregate intrinsic value of options outstanding and options exercisable as of June 30, 2006 was \$8.3 million and \$7.1 million, respectively.

*Restricted Stock Awards*

The Company's stock incentive plans also provide for awards of restricted shares of common stock and other stock-based incentive awards and from time to time the Company has used restricted stock awards for incentive or retention purposes. Restricted stock awards have time-based vesting and/or performance conditions and are generally subject to forfeiture if employment terminates prior to the end of the service period or if the prescribed performance criteria are not met. Restricted stock awards are valued at the grant date based upon the market price of the Company's common stock and the fair value of each award is charged to expense over the service period.

In fiscal 2006, new awards of stock-based compensation have principally consisted of restricted stock awards. During the nine months ended June 30, 2006, the Company granted an aggregate of 3.8 million shares of restricted stock to its employees. These awards principally consisted of broad-based grants covering substantially all employees. One broad-based grant was intended to provide performance emphasis and incentive compensation through vesting tied to each employee's performance against individual goals for fiscal year 2006. Certain senior management personnel also received additional restricted stock awards having vesting tied to the Company's achievement of an operating profit. For purposes of the restricted stock awards, operating profit or loss excludes stock-based compensation expenses and special charges. The Company achieved an operating profit (as defined) in the fiscal 2006 third quarter. These awards also contain a requirement for continued service through November 8, 2006. Another broad-based grant of restricted stock was intended to provide long-term incentive compensation; these awards vest ratably over a period of four years, and require continued service.

The fair value of each award is charged to expense over the service period. The actual amounts of expense will depend on the number of awards that ultimately vest upon the satisfaction of the related performance and service conditions. The following table summarizes restricted stock award activity (shares in thousands):

Number of	Weighted- Average
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	<b>Shares</b>	<b>Grant Date Fair Value</b>
Nonvested shares at September 30, 2005	423	\$ 2.13
Granted	3,846	\$ 2.64
Vested	(419)	\$ 2.44
Forfeited	(223)	\$ 2.47
Nonvested shares at June 30, 2006	3,627	\$ 2.61

The total fair value of shares vested during the nine months ended June 30, 2006 was \$1.3 million. As of June 30, 2006 there was unrecognized compensation expense of \$4.4 million related to unvested restricted stock awards, which the Company expects to recognize over a weighted-average period of 2.4 years.



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**NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (continued)**  
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*Employee Stock Purchase Plan*

The Company has an employee stock purchase plan under which eligible employees may authorize the Company to withhold up to 10% of their compensation for each pay period to purchase shares of the Company's common stock, subject to certain limitations. Offering periods generally commence on the first trading day of March and September of each year and are generally six months in duration, but may be terminated earlier under certain circumstances. Purchases are made at the end of each offering period, at a discount of 5% from the fair market value on the purchase date. Under SFAS 123R, the plan is non-compensatory and the Company has recorded no compensation expense in connection therewith. During the nine months ended June 30, 2006 and 2005, the Company issued 59,000 and 349,000 shares of its common stock under the employee stock purchase plan for net proceeds of \$209,000 and \$689,000, respectively.

**5. Commitments and Contingencies**

Various lawsuits, claims and proceedings have been or may be instituted or asserted against Conexant or Mindspeed, including those pertaining to product liability, intellectual property, environmental, safety and health and employment matters. In connection with the Distribution, Mindspeed assumed responsibility for all contingent liabilities and current and future litigation against Conexant or its subsidiaries to the extent such matters relate to the Mindspeed business.

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 the Company will be able to license a third party's intellectual property. 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, management of the Company believes the disposition of such matters will not have a material adverse effect on the financial condition or results of operations of the Company.

**6. Special Charges**

Special charges consist of the following (in thousands):

	<b>Three months ended</b>		<b>Nine months ended</b>	
	<b>June 30,</b>		<b>June 30,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
Asset impairments	\$	\$	\$	\$ 604
Restructuring charges	1,053	(125)	2,234	5,252
	\$ 1,053	\$ (125)	\$ 2,234	\$ 5,856

*Asset Impairments*

During the first nine months of fiscal 2005, the Company recorded asset impairment charges totaling \$604,000 related to property and equipment that it determined to abandon or scrap.

*Restructuring Charges*

*Mindspeed 2006 Restructuring Plan* In March 2006, the Company implemented a restructuring plan under which it reduced its workforce by approximately 21 employees. The affected employees included approximately nine persons in research and development, six in sales and marketing and six in general and administrative functions. In connection with the 2006 restructuring plan, the company recorded restructuring charges of \$786,000 in the fiscal 2006 third quarter. The restructuring charges included \$587,000 for severance benefits payable to six affected employees and \$199,000 for the value of stock-based compensation awards that will vest without future service to the company. In connection with this plan, the Company recorded \$1.7 million of restructuring charges for the first nine months of fiscal 2006. These restructuring charges included \$1.4 million of severance benefits payable to 21 employees and

\$348,000 for the value of stock-based compensation awards that vest without future service to the Company.

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**MINDSPEED TECHNOLOGIES, INC.**  
**NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (continued)**  
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The Company expects that the workforce reductions will reduce its quarterly operating expenses by approximately \$700,000, including approximately \$400,000 in research and development expenses and approximately \$300,000 in selling, general and administrative expenses. The Company expects to realize the full benefit of these reductions beginning in the fiscal 2006 fourth quarter. However, the Company intends to reinvest substantially all of such cost savings back into its research and development programs. Consequently, the Company does not expect that the 2006 restructuring plan will result in a long-term reduction in its operating expenses. Activity and liability balances related to the Mindspeed 2006 restructuring plan through June 30, 2006 are as follows (in thousands):

	<b>Workforce Reductions</b>
Charged to costs and expenses	\$ 1,742
Cash payments	(600)
Non-cash charges	(348)
Restructuring balance, June 30, 2006	\$ 794

*Mindspeed 2004 Restructuring Plan* In October 2004, the Company announced a restructuring plan intended to reduce its operating expenses while focusing its research and development investment in key high-growth markets, including voice-over-Internet protocol (VoIP) and high-performance analog applications. The expense reduction actions included workforce reductions and the closure of design centers in Herzlia, Israel and Lisle, Illinois. Approximately 80% of the expense reductions were derived from the termination of research and development programs which the Company believes had a longer return-on-investment timeframe or that addressed slower growth markets. The affected research and development programs were principally the Company's asynchronous transfer mode (ATM)/multi-protocol label switching (MPLS) network processor products and, to a lesser extent, its T/E carrier transmission products. The remainder of the cost savings came from the selling, general and administrative functions. The Company completed substantially all of these actions during fiscal 2005, reducing its workforce by approximately 90 employees.

In connection with these actions, the Company recorded fiscal 2005 restructuring charges of approximately \$5.9 million. The restructuring charges included an aggregate of \$3.4 million for the workforce reductions, based upon estimates of the cost of severance benefits for the affected employees, and approximately \$2.5 million related to contractual obligations for the purchase of design tools and other services in excess of anticipated requirements. During the nine months ended June 30, 2006, the Company recorded additional charges of \$327,000 for severance and related benefits payable to the affected employees. Activity and liability balances related to the Mindspeed 2004 restructuring plan through June 30, 2006 are as follows (in thousands):

	<b>Workforce Reductions</b>	<b>Facility and Other</b>	<b>Total</b>
Charged to costs and expenses	\$ 3,412	\$ 2,517	\$ 5,929
Cash payments	(2,575)	(1,546)	(4,121)
Restructuring balance, September 30, 2005	837	971	1,808
Charged to costs and expenses	327		327
Cash payments	(1,035)	(577)	(1,612)
Restructuring balance, June 30, 2006	\$ 129	\$ 394	\$ 523

*Other Restructuring Plans* In fiscal 2001, 2002 and 2003, the Company implemented a number of cost reduction initiatives to improve its operating cost structure. The cost reduction initiatives included workforce reductions, significant reductions in capital spending, the consolidation of certain facilities and salary reductions for the senior management team. During the nine months ended June 30, 2006, the Company made cash payments of \$1.3 million under these restructuring plans and charged \$165,000 to costs and expenses related to contractual obligations. As of June 30, 2006, the Company's remaining liabilities under these restructuring plans totaled \$1.0 million, representing amounts payable under non-cancelable leases, severance benefits to affected employees and other contractual commitments.

As of June 30, 2006, the Company has a remaining accrued restructuring balance for all restructuring plans totaling \$2.3 million (including \$174,000 classified as a long-term liability), representing obligations under non-cancelable leases and other contractual commitments. The Company expects to pay these obligations over their respective

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**MINDSPEED TECHNOLOGIES, INC.**  
**NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (continued)**  
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terms, which expire at various dates through fiscal 2008. The payments are expected to be funded from available cash balances and funds from product sales and are not expected to impact significantly the Company's liquidity.

**7. Related Party Transactions**

The Company leases its headquarters and principal design center in Newport Beach, California from Conexant. For the nine months ended June 30, 2006 and 2005, rent and operating expenses paid to Conexant were \$4.8 million and \$3.1 million, respectively.

Product sales to Conexant were \$1.2 million for the nine months ended June 30, 2005; the Company made no sales to Conexant during the nine months ended June 30, 2006.

**8. Subsequent Events**

In July 2006, the Company implemented a restructuring plan under which it will reduce its workforce by approximately 25 employees. The Company expects that the workforce reduction will reduce quarterly operating expenses by approximately \$1 million. However, the Company plans to reinvest substantially all of the cost savings from its workforce reductions into research and development programs. The Company expects that the workforce reduction will result in special charges totaling approximately \$750,000 for severance benefits payable to affected employees and for the value of stock-based compensation that will vest without future service to the Company.

**Table of Contents****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 our fiscal year ended September 30, 2005.

**Overview**

We design, develop and sell semiconductor networking solutions for communications applications in enterprise, access, metropolitan and wide-area networks. Our products, ranging from optical network transceiver solutions to voice and Internet protocol (IP) processors, are classified into three focused product families: high-performance analog products, multiservice access digital signal processor (DSP) products and wide area networking (WAN) communications products. Our products are sold to original equipment manufacturers (OEMs) for use in a variety of network infrastructure equipment, including mixed media gateways, high-speed routers, switches, access multiplexers, cross-connect systems, add-drop multiplexers, digital loop carrier equipment, IP private branch exchanges (PBXs) and optical modules. Service providers use this equipment for the processing, transmission and switching of high-speed voice, data and video traffic, including advanced services such as voice-over-IP (VoIP), within different segments of the communications network. Our OEM customers include Alcatel Data Networks, S.A., Cisco Systems, Inc., McData Corporation, Nortel Networks, Inc. and Siemens A.G.

**Trends and Factors Affecting Our Business**

Our products are components of network infrastructure equipment. As a result, we rely on network infrastructure OEMs to select our products from among alternative offerings to be designed into their equipment. These design wins are an integral part of the long sales cycle for our 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. We believe our close relationships with leading network infrastructure OEMs facilitate early adoption of our products during development of their products, enhance our ability to obtain design wins and encourage adoption of our technology by the industry.

We market and sell our semiconductor products directly to network infrastructure OEMs. We also sell our products indirectly through electronic component distributors and third-party electronic manufacturing service providers, who manufacture products incorporating our semiconductor networking solutions for OEMs. Sales to distributors accounted for approximately 47% and 49% of our revenues for fiscal 2005 and the first nine months of fiscal 2006, respectively. Sales to customers located outside the United States, primarily in the Asia-Pacific region and Europe, were approximately 71% and 69%, respectively, of our net revenues for fiscal 2005 and the first nine months of fiscal 2006. We believe a substantial portion of the products we sell to OEMs and third-party manufacturing service providers in the Asia-Pacific region is ultimately shipped to end markets in the Americas and Europe.

We have significant research, development, engineering and product design capabilities. Our success depends to a substantial degree upon our ability to develop and introduce in a timely fashion new products and enhancements to our existing products that meet changing customer requirements and emerging industry standards. We have made, and plan to make, substantial investments in research and development and to participate in the formulation of industry standards. We spent approximately \$71.4 million and \$48.6 million on research and development for fiscal 2005 and the first nine months of fiscal 2006, respectively. We seek to maximize our return on our research and development spending by focusing our research and development investment in what we believe are key high-growth markets, including VoIP and high-performance analog applications.

We are dependent upon third parties for the manufacture, assembly and testing of our products. Our ability to bring new products to market, to fulfill orders and to achieve long-term revenue growth is dependent on our ability to obtain sufficient external manufacturing capacity, including wafer fabrication capacity. Periods of upturns in the semiconductor industry may be characterized by rapid increases in demand and a shortage of capacity for wafer fabrication and assembly and test services. In such periods, we may experience longer lead times or indeterminate delivery schedules, which may adversely affect our ability to fulfill orders for our products. During periods of



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capacity shortages for manufacturing, assembly and testing services, our primary foundries and other suppliers may devote their limited capacity to fulfill the requirements of other clients that are larger than we are, or who have superior contractual rights to enforce manufacture of their products, including to the exclusion of producing our products. We may also incur increased manufacturing costs, including costs of finding acceptable alternative foundries or assembly and test service providers.

In order to achieve profitability, we must achieve substantial revenue growth. Our ability to achieve the necessary revenue growth will depend on increased demand for network infrastructure equipment that incorporates our products, which in turn depends primarily on the level of capital spending by communications service providers. We believe the market for network infrastructure equipment in general, and for communications semiconductors in particular, offers attractive long-term growth prospects due to increasing demand for network capacity, the continued upgrading and expansion of existing networks and the build-out of telecommunication networks in developing countries. However, 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. These factors have caused substantial fluctuations in our revenues and our results of operations in the past, and we may experience cyclical fluctuations in our business in the future.

In July 2006, we implemented a restructuring plan under which we will reduce our workforce by approximately 25 employees. We expect that our workforce reduction will reduce quarterly operating expenses by approximately \$1 million. However, we plan to reinvest substantially all of the cost savings from our workforce reductions into our research and development programs.

### **Spin-off from Conexant Systems, Inc.**

On June 27, 2003, Conexant completed the distribution to Conexant stockholders of all outstanding shares of common stock of Mindspeed, then a wholly owned subsidiary of Conexant. In the distribution, each Conexant stockholder received one share of our common stock, par value \$.01 per share (including an associated preferred share purchase right), for every three shares of Conexant common stock held and cash for any fractional share of our common stock. Following the distribution, we began operations as an independent, publicly held company. Our common stock trades on The Nasdaq Stock Market under the ticker symbol `MSPD`.

Prior to the distribution, Conexant transferred to us the assets and liabilities of its Mindspeed business, including the stock of certain subsidiaries, and certain other assets and liabilities which were allocated to us under the Distribution Agreement entered into between us and Conexant. Also prior to the distribution, Conexant contributed to us cash in an amount such that at the time of the distribution our cash balance was \$100 million. We issued to Conexant a warrant to purchase 30 million shares of our common stock at a price of \$3.408 per share, exercisable for a period of ten years after the distribution. We and Conexant also entered into a Credit Agreement, an Employee Matters Agreement, a Tax Allocation Agreement, a Transition Services Agreement and a Sublease.

### **Stock-Based Compensation Programs**

We use stock-based compensation to attract and retain employees and to provide long-term incentive compensation that aligns the interests of our employees with those of our stockholders. Prior to fiscal 2006, our stock-based compensation consisted principally of stock options. Eligible employees received grants of stock options at the time of hire; we also made broad-based stock option grants covering substantially all of our employees annually. Stock option awards have exercise prices not less than the market price of our common stock at the grant date and a contractual term of eight or ten years, and are subject to time-based vesting (generally over four years). From time to time we have also used restricted stock awards with time-based vesting for incentive or retention purposes.

For fiscal 2006, we have revised our stock-based compensation arrangements to provide current and long-term incentive compensation, principally through restricted stock awards. During the first nine months of fiscal 2006, we granted an aggregate of 3.8 million shares of restricted stock to our employees. These awards principally consisted of broad-based grants, covering substantially all of our employees. One broad-based grant was intended to provide performance emphasis and incentive compensation through vesting tied to each employee's performance against individual goals for fiscal year 2006. Another broad-based grant of restricted stock was intended to provide long-term incentive compensation; these awards vest ratably over a period of four years, and require continued service.





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Certain senior management personnel also received additional restricted stock awards having vesting tied to our achievement of an operating profit. For purposes of the restricted stock awards, operating profit or loss excludes stock-based compensation expenses and special charges. We achieved an operating profit (as defined) in the fiscal 2006 third quarter. These awards also contain a requirement for continued service through November 8, 2006. From time to time, we also grant stock options or other stock-based awards for incentive or retention purposes. We expect to formally review, and may further revise, our compensation arrangements for fiscal 2007 and thereafter based on regular assessment of the effectiveness of our compensation arrangements and to keep our overall compensation package at market levels.

Effective October 1, 2005, we adopted SFAS 123R, Share-Based Payment. SFAS 123R requires that we account for all stock-based compensation transactions using a fair-value method and recognize the fair value of each award as an expense over the service period. As required by SFAS 123R, our stock-based compensation expense for fiscal 2006 includes the fair value of new awards, modified awards and any unvested awards outstanding at October 1, 2005. However, the consolidated financial statements for periods prior to the adoption of SFAS 123R have not been restated to reflect the fair value method of accounting for stock-based compensation. The fair value of restricted stock awards is based upon the market price of our common stock at the grant date. We estimate the fair value of stock option awards, as of the grant date, using the Black-Scholes option-pricing model. The fair value of each award is recognized on a straight-line basis over the vesting or service period.

Stock-based compensation expense totaling \$5.6 million and \$300,000 for the first nine months of fiscal 2006 and 2005, respectively, is included in cost of goods sold, research and development expenses, selling, general and administrative expenses and special charges. The increase principally reflects the cost of restricted stock and other awards made during the first nine months of fiscal 2006, as well as the cost of awards outstanding at October 1, 2005 but vesting after that date. We expect that stock-based compensation expense for fiscal 2006 will be approximately \$7.6 million. However, the actual amount of expense we record in each fiscal period will depend on a number of factors, including the number of awards, the market price of our common stock, the vesting periods, the number of awards that ultimately vest and other factors. See Critical Accounting Policies and Estimates Stock-Based Compensation.

**Critical Accounting Policies and Estimates**

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 inventories, revenue recognition, allowances for doubtful accounts, stock-based compensation and income taxes. 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.

*Inventories* We write down our inventory for estimated obsolete 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. In the event we experience unanticipated demand and are able to sell a portion of the inventories we have previously written down, our gross margins will be favorably affected.

*Revenue Recognition* We recognize revenues when the following fundamental criteria are met: (i) persuasive evidence of an arrangement exists; (ii) delivery has occurred; (iii) our price to the customer is fixed or determinable; and (iv) collection of the sales price is reasonably assured. Delivery occurs when goods are shipped and title and risk of loss transfer to the customer, in accordance with the terms specified in the arrangement with the customer. Revenue recognition is deferred in all instances where the earnings process is incomplete. We make certain product sales 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 estimated sales returns and allowances in the same period as the related revenues are

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recognized. We base these estimates on our historical experience or the specific identification of an event necessitating a reserve. To the extent actual sales returns differ from our estimates, our future results of operations may be affected. Development revenue is recognized when services are performed and was not significant for any of the periods presented.

*Allowance for Doubtful Accounts* We maintain allowances for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. Our estimates of such losses are based on an assessment of the aging of outstanding accounts receivable and a review of specific customer accounts. If the financial condition of our customers were to deteriorate, our actual losses may exceed our estimates and additional allowances would be required.

*Stock-Based Compensation* We account for stock-based compensation in accordance with SFAS No. 123R,

Share-Based Payment. SFAS 123R requires that we account for all stock-based compensation transactions using a fair-value method and recognize the fair value of each award as an expense over the service period. The fair value of restricted stock awards is based upon the market price of our common stock at the grant date. We estimate the fair value of stock option awards, as of the grant date, using the Black-Scholes option-pricing model. The use of the Black-Scholes model requires that we make a number of estimates, including the expected option term, the expected volatility in the price of our common stock, the risk-free rate of interest and the dividend yield on our common stock. If our expected option term and stock-price volatility assumptions were different, the resulting determination of the fair value of stock option awards could be materially different. In addition, judgment is also required in estimating the number of share-based awards that we expect will ultimately vest upon the fulfillment of service conditions (such as time-based vesting) or the achievement of specific performance conditions. If the actual number of awards that ultimately vest differs significantly from these estimates, stock-based compensation expense and our results of operations could be materially impacted.

*Deferred Income Taxes* We have provided a full valuation allowance against our U.S federal and state deferred tax assets. If sufficient evidence of our ability to generate future U.S federal and/or state taxable income becomes apparent, we may be required to reduce our valuation allowance, resulting in income tax benefits in our statement of operations. We evaluate the realizability of our deferred tax assets and assess the need for a valuation allowance quarterly.

**Recent Accounting Pronouncements**

We adopted SFAS No. 151, Inventory Costs, an amendment of Accounting Research Bulletin (ARB) No. 43, Chapter 4 as of the beginning of fiscal 2006, with no material effect on our financial condition or results of operations. In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections, which replaces APB Opinion No. 20, Accounting Changes, and SFAS No. 3, Reporting Accounting Changes in Interim Financial Statements. SFAS No. 154 applies to all voluntary changes in accounting principle and requires retrospective application (a term defined by the statement) to prior periods' financial statements, unless it is impracticable to determine the effect of a change. It also applies to changes required by an accounting pronouncement that does not include specific transition provisions. SFAS 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. We will adopt SFAS No. 154 as of the beginning of fiscal 2007, and we do not expect that the adoption of SFAS 154 will have a material impact on our financial condition or results of operations.

In July 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48) which clarifies the accounting for uncertainty in income taxes recognized in the financial statements in accordance with FASB Statement No. 109, Accounting for Income Taxes. This pronouncement recommends a recognition threshold and measurement process for recording in the financial statements uncertain tax positions taken or expected to be taken in the Company's tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods and disclosure requirements for uncertain tax positions. The accounting provisions of FIN 48 will be effective for the Company beginning January 1, 2007. The Company is in the process of evaluating the effect, if any, the adoption of FIN 48 will have on its financial statements.

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

The following table summarizes our net revenues:

(\$ in millions)	Three months ended June 30,			Nine months ended June 30,		
	2006	Change	2005	2006	Change	2005
Multiservice access DSP products	\$ 8,896	(1)%	\$ 8,974	\$ 28,733	19%	\$ 24,188
High-performance analog products	11,925	74%	6,854	31,935	59%	20,028
WAN communications products	15,073	27%	11,910	43,039	18%	36,482
Net revenues	\$ 35,894	29%	\$ 27,738	\$ 103,707	29%	\$ 80,698

For the fiscal 2006 third quarter, the 29% increase in our revenues compared to the third quarter of fiscal 2005 reflects higher sales volumes in our high-performance analog products and our WAN communications products, partially offset by lower sales of our multiservice access DSP products. Revenues from our high-performance analog products increased by \$5.1 million, or 74%, benefiting from increased shipments of our crosspoint switches and video infrastructure products. We also experienced increased demand for our physical media dependent devices for use in infrastructure equipment for fiber-to-the-premise deployments and metropolitan area networks partly due to resolution of product supply issues we had experienced in earlier quarters. Sales of our WAN communications products increased by \$3.2 million, or 27%, reflecting increased demand for our T/E carrier transmission products. Revenues from our multiservice access DSP products decreased by \$78,000, or 1%. We believe that an inventory build-up in prior quarters of one of our voice-over-IP products at one of our key OEM customers adversely affected our sales of these products for the fiscal 2006 third quarter as the customer transitioned its inventory management practices to a tighter supply chain model, which we expect will have the effect of reducing that customer's inventory levels. In addition, we believe that certain customers may have purchased product ahead of their actual demand during the fiscal 2006 third quarter.

For the first nine months of fiscal 2006, the 29% increase in our revenues compared to the similar fiscal 2005 period reflects higher sales volumes across each of our product families. Revenues from our multiservice access DSP products increased \$4.5 million, or 19%, reflecting increased sales volumes across the majority of our VoIP product families. We believe we are benefiting from the increasing deployment of IP-based networks both in new network buildouts (particularly in Asia) and the replacement of circuit-switched networks. Revenues from our high-performance analog products increased by \$11.9 million, or 59%, benefiting from increased shipments of our crosspoint switches, physical media dependent devices and video infrastructure products. Sales of our WAN communications products increased by \$6.6 million, or 18%, reflecting increased shipments of our T/E carrier transmission products, partially offset by lower demand for our ATM/MPLS network processor products.

**Gross Margin**

(\$ in millions)	Three months ended June 30,			Nine months ended June 30,		
	2006	Change	2005	2006	Change	2005
Gross margin	\$24.7	26%	\$19.5	\$71.8	28%	\$56.2
Percent of net revenues	69%		70%	69%		70%

Gross margin represents revenues less cost of goods sold. As a fabless semiconductor company, we use third parties (including Taiwan Semiconductor Manufacturing Co., Ltd. (TSMC), Jazz Semiconductor, Inc. and Amkor Technology, Inc.) for wafer fabrication and 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; labor and overhead costs associated with product procurement; and sustaining engineering expenses pertaining to products sold.

Our gross margin for the fiscal 2006 third quarter increased \$5.2 million over the comparable fiscal 2005 period, principally reflecting the 29% increase in our quarterly revenues and the favorable effect of increased manufacturing volumes in the fiscal 2006 period. Our gross margin for the fiscal 2006 third quarter also benefited from higher than anticipated manufacturing yields on certain products. The change in provision for excess and obsolete inventories was a credit of \$70,000 for the fiscal 2006 third quarter, compared to a change in provision of \$238,000 for the comparable fiscal 2005 period. Our gross margin for the third quarter of fiscal 2006 and 2005 also benefited from the sale of inventories with an original cost of \$1.1 million and \$1.7 million, respectively, that we had written down to a zero cost basis during fiscal 2001. These sales resulted from renewed demand for certain products that was not anticipated at the

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time of the write-downs. The previously written-down inventories were generally sold at prices which exceeded their original cost.

Our gross margin for the first nine months of fiscal 2006 increased \$15.6 million over the comparable fiscal 2005 period, principally reflecting the 29% increase in our revenues and the favorable effect of increased manufacturing volumes in the fiscal 2006 period. Our gross margin for the first nine months of fiscal 2006 also benefited from higher than anticipated manufacturing yields on certain products. The change in provision for excess and obsolete inventories was a credit of \$612,000 for the first nine months of fiscal 2006, compared to a change in provision of \$977,000 for the comparable fiscal 2005 period. Our gross margin for the first nine months of fiscal 2006 and 2005 also benefited from the sale of inventories with an original cost of \$3.9 million and \$7.2 million, respectively, that we had written down to a zero cost basis during fiscal 2001.

In fiscal 2001, we recorded an aggregate of \$83.5 million of inventory write-downs, reducing the cost basis of the affected inventories to zero. The fiscal 2001 inventory write-downs resulted from the sharply reduced end-customer demand for network infrastructure equipment 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. The inventories written down in fiscal 2001 principally consisted of multiservice access processors and DSL transceivers.

We assess the recoverability of our inventories at least quarterly through a review of inventory levels in relation to foreseeable demand (generally over twelve 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 OEMs that have designed our products into network infrastructure 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. 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.

From the time of the fiscal 2001 inventory write-downs through June 30, 2006, we scrapped a portion of these inventories having an original cost of \$38.7 million and sold a portion of these inventories with an original cost of \$30.3 million. The sales resulted from increased demand beginning in the first quarter of fiscal 2002 which was not anticipated at the time of the write-downs. As of June 30, 2006, we continued to hold inventories with an original cost of \$14.5 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 by an amount equal to the original cost of the zero-cost basis inventory sold. 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.

**Table of Contents****Research and Development**

(\$ in millions)	Three months ended June 30,			Nine months ended June 30,		
	2006	Change	2005	2006	Change	2005
Research and development	\$15.0	(10)%	\$16.7	\$48.6	(12)%	\$55.0
Percent of net revenues	42%		60%	47%		68%

Our research and development (R&D) expenses consist principally of direct personnel costs, photomasks, electronic design automation tools and pre-production evaluation and test costs. The decrease in R&D expenses for the third quarter of fiscal 2006 compared to the third quarter of fiscal 2005 includes a \$1.3 million decrease in compensation and personnel-related costs partly attributable to a one-time vacation requirement, and a \$721,000 decrease in depreciation expense, principally resulting from the expense reduction actions we completed in fiscal 2005. During fiscal 2005, we reduced our workforce and closed design centers in Herzlia, Israel and Lisle, Illinois. The affected research and development programs were principally our asynchronous transfer mode (ATM)/multi-protocol label switching (MPLS) network processor products and, to a lesser extent, our T/E carrier transmission products. These cost savings were partly offset by increased spending directed toward VoIP products and our high-performance analog products. The decrease in R&D expenses also reflects lower costs for materials, photomasks and preproduction devices. These decreases were partially offset by a \$692,000 increase in stock-based compensation expense. The decrease in R&D expenses for the first nine months of fiscal 2006 compared to the first nine months of fiscal 2005 includes a \$3.7 million decrease in compensation and personnel-related costs and a \$2.0 million decrease in depreciation expense, principally resulting from the expense reduction actions we completed in fiscal 2005. The decrease in R&D expenses also reflects costs for photomasks and preproduction devices. These decreases were partially offset by a \$1.9 million increase in stock-based compensation expense.

**Selling, General and Administrative**

(\$ in millions)	Three months ended June 30,			Nine months ended June 30,		
	2006	Change	2005	2006	Change	2005
Selling, general and administrative	\$11.8	9%	\$10.8	\$35.3	11%	\$31.9
Percent of net revenues	33%		39%	34%		40%

Our selling, general and administrative (SG&A) expenses include personnel costs, independent sales representative commissions and product marketing, applications engineering and other marketing costs. Our SG&A expenses also include costs of corporate functions including accounting, finance, legal, human resources, information systems and communications. The increase in our SG&A expenses for the third quarter of fiscal 2006 compared to the third quarter of fiscal 2005 reflects a \$1.3 million increase in stock-based compensation expense, partially offset by the benefit of a one-time vacation requirement. The increase also includes higher sales commissions associated with the 29% increase in sales for the third quarter of fiscal 2006 compared to the similar fiscal 2005 period.

The increase in our SG&A expenses for the first nine months of fiscal 2006 compared to the similar fiscal 2005 period principally reflects a \$2.7 million increase in stock-based compensation expense. The increase also reflects increased compensation and personnel-related costs and higher sales commissions associated with the 29% increase in sales for the first nine months of fiscal 2006 compared to the similar fiscal 2005 period.

**Amortization of Intangible Assets**

(\$ in millions)	Three months ended June 30,			Nine months ended June 30,		
	2006	Change	2005	2006	Change	2005
Amortization of intangible assets	\$	(100)%	\$0.8	\$	(100)%	\$20.5

Amortization of intangible assets decreased to zero for the third quarter and first nine months of fiscal 2006 because the remainder of our intangible assets became fully amortized during fiscal 2005, reducing their carrying value to zero. Intangible assets were amortized over periods averaging approximately five years for each major asset class and



extending to various dates through June 2005. We will not record any additional amortization expense on our existing intangible assets in future periods.

**Table of Contents****Special Charges**

Special charges consist of the following:

(\$ in millions)	Three months ended		Nine months ended	
	June 30,		June 30,	
	2006	2005	2006	2005
Asset impairments	\$	\$	\$	\$ 0.6
Restructuring charges	1.1	(0.1)	2.2	5.3
	\$ 1.1	\$ (0.1)	\$ 2.2	\$ 5.9

**Asset Impairments**

During the first nine months of fiscal 2005, we recorded asset impairment charges totaling \$604,000 related to property and equipment that we determined to abandon or scrap.

We continually monitor and review long-lived assets, including fixed assets and intangible assets, for possible impairment. Future impairment tests may result in significant write-downs of the value of our assets.

**Restructuring Charges**

*Mindspeed 2006 Restructuring Plan* In March 2006, we implemented a restructuring plan under which we reduced our workforce by approximately 21 employees. The affected employees included approximately nine persons in research and development, six in sales and marketing and six in general and administrative functions. In connection with the 2006 restructuring plan, we recorded restructuring charges of \$786,000 in the fiscal 2006 third quarter. The restructuring charges included \$587,000 for severance benefits payable to six affected employees and \$199,000 for the value of stock-based compensation awards that will vest without future service to us. In connection with this plan, we recorded \$1.7 million of restructuring charges for the first nine months of fiscal 2006. These restructuring charges included \$1.4 million of severance benefits payable to 21 employees and \$348,000 for the value of stock-based compensation awards that vest without future service to us.

We expect that the workforce reductions will reduce our quarterly operating expenses by approximately \$700,000, including approximately \$400,000 in research and development expenses and approximately \$300,000 in selling, general and administrative expenses. We expect to realize the full benefit of these reductions beginning in the fiscal 2006 fourth quarter. However, we intend to reinvest substantially all of such cost savings back into our research and development programs. Consequently, we do not expect that the 2006 restructuring plan will result in a long-term reduction in our operating expenses.

Activity and liability balances related to the Mindspeed 2006 restructuring plan through June 30, 2006 are as follows (in thousands):

	<b>Workforce Reductions</b>
Charged to costs and expenses	\$ 1,742
Cash payments	(600)
Non-cash charges	(348)
Restructuring balance, June 30, 2006	\$ 794

*Mindspeed 2004 Restructuring Plan* In October 2004, we announced a restructuring plan intended to reduce our operating expenses while focusing our research and development investment in key high-growth markets, including voice-over-Internet protocol (VoIP) and high-performance analog applications. The expense reduction actions included workforce reductions and the closure of design centers in Herzlia, Israel and Lisle, Illinois. Approximately 80% of the expense reductions were derived from the termination of research and development programs which we believe had a longer return-on-investment timeframe or that addressed slower growth markets. The affected research

and development programs were principally our asynchronous transfer mode (ATM)/multi-protocol label switching (MPLS) network processor products and, to a lesser extent, our T/E carrier transmission products. The remainder of the cost savings came from the selling, general and administrative functions. We completed substantially all of these actions during fiscal 2005, reducing our workforce by approximately 90 employees.

In connection with these actions, we recorded fiscal 2005 restructuring charges of approximately \$5.9 million. The restructuring charges included an aggregate of \$3.4 million for the workforce reductions, based upon estimates of

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the cost of severance benefits for the affected employees, and approximately \$2.5 million related to contractual obligations for the purchase of design tools and other services in excess of anticipated requirements. During the nine months ended June 30, 2006, we recorded additional charges of \$327,000 for severance and related benefits payable to the affected employees. Activity and liability balances related to the Mindspeed 2004 restructuring plan through June 30, 2006 are as follows (in thousands):

	<b>Workforce Reductions</b>	<b>Facility and Other</b>	<b>Total</b>
Charged to costs and expenses	\$ 3,412	\$ 2,517	\$ 5,929
Cash payments	(2,575)	(1,546)	(4,121)
Restructuring balance, September 30, 2005	837	971	1,808
Charged to costs and expenses	327		327
Cash payments	(1,035)	(577)	(1,612)
Restructuring balance, June 30, 2006	\$ 129	\$ 394	\$ 523

*Other Restructuring Plans* In fiscal 2001, 2002 and 2003, we implemented a number of cost reduction initiatives to improve our operating cost structure. The cost reduction initiatives included workforce reductions, significant reductions in capital spending, the consolidation of certain facilities and salary reductions for the senior management team. During the nine months ended June 30, 2006, we made cash payments of \$1.3 million under these restructuring plans and charged \$165,000 to costs and expenses related to contractual obligations. As of June 30, 2006, our remaining liabilities under these restructuring plans totaled \$1.0 million, representing amounts payable under non-cancelable leases, severance benefits to affected employees and other contractual commitments.

As of June 30, 2006, we have a remaining accrued restructuring balance for all restructuring plans totaling \$2.3 million (including \$174,000 classified as a long-term liability), representing obligations under non-cancelable leases and other contractual commitments. We expect to pay these obligations over their respective terms, which expire at various dates through fiscal 2008. The payments are expected to be funded from available cash balances and funds from product sales and are not expected to impact significantly our liquidity.

**Interest Expense**

(\$ in millions)	<b>Three months ended June 30,</b>		<b>Nine months ended June 30,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
Interest expense	\$ 0.6	\$ 0.6	\$ 1.7	\$ 1.2

Interest expense represents interest on the \$46 million convertible senior notes we issued in December 2004. Interest expense increased for the first nine months of fiscal 2006, as compared to the comparable fiscal 2005 period, because the notes were outstanding during the entire fiscal 2006 periods.

**Other Income (Expense), Net**

(\$ in millions)	<b>Three months ended June 30,</b>		<b>Nine months ended June 30,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
Other income (expense), net	\$ 0.2	\$ 0.4	\$ 0.9	\$ 0.8

Other income (expense) principally consists of interest income, foreign exchange gains and losses, franchise taxes and other non-operating gains and losses. The decrease in other income for the third quarter principally reflects lower interest income as a result of lower cash, cash equivalents and marketable securities and foreign exchange losses. The

increase in other income in the first nine months of fiscal 2006 as compared to the fiscal 2005 periods principally reflects higher interest income resulting from the higher cash, cash equivalent and marketable security balances and higher interest rates that prevailed during the fiscal 2006 periods.

**Provision for Income Taxes**

Our provision for income taxes for the third quarter and first nine months of fiscal 2006 and 2005 principally consisted of income taxes incurred by our foreign subsidiaries. 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 U.S. federal and state income tax benefits (principally net operating losses we can carry forward to future years) which arose during the first nine months of fiscal 2006 and 2005 will not be realized. Accordingly, we have not recognized any income tax

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benefits relating to our U.S. federal and state operating losses for those periods and we do not expect to recognize any income tax benefits relating to future operating losses until we believe that such tax benefits are more likely than not to be realized. We expect that our provision for income taxes for fiscal 2006 will principally consist of income taxes related to our foreign operations.

**Liquidity and Capital Resources**

Cash used in operating activities was \$14.4 million for the first nine months of fiscal 2006 compared to \$22.8 million for the first nine months of fiscal 2005. Operating cash flows for the first nine months of fiscal 2006 reflect our net loss of \$17.2 million, partially offset by non-cash charges (depreciation, stock-based compensation expense and other) of \$10.6 million, and net working capital increases of approximately \$7.8 million.

The net working capital increases for the first nine months of fiscal 2006 consisted principally of a \$8.9 million increase in net inventories resulting from our decision to increase inventory levels to satisfy anticipated customer demand and to mitigate supply constraints. The working capital increases also included a \$1.1 million increase in accounts receivable resulting from an increase in our net revenues offset by a slight improvement in our average collection period. These amounts were partially offset by a \$1.5 million increase in accounts payable principally related to the timing of vendor payments and other working capital changes.

Cash provided by investing activities of \$14.3 million for the first nine months of fiscal 2006 principally consisted of sales of marketable securities (net of purchases) of \$17.3 million, partially offset by capital expenditures of \$3.0 million. For the first nine months of fiscal 2005, cash used in investing activities of \$46.3 million principally consisted of purchases of marketable securities of \$43.3 million and capital expenditures of \$3.2 million, partly offset by proceeds from asset sales of \$149,000.

Cash provided by financing activities of \$5.2 million for the first nine months of fiscal 2006 consisted of proceeds from the exercise of stock options. Cash provided by financing activities of \$46.4 million for the first nine months of fiscal 2005 consisted of net proceeds of \$43.9 million from the sale of \$46 million principal amount of convertible senior notes and proceeds of \$2.9 million from the exercise of stock options and warrants, partially offset by debt issuance costs of \$433,000.

*Convertible Senior Notes Offering*

In December 2004, we sold \$46.0 million aggregate principal amount of Convertible Senior Notes due 2009 for net proceeds (after discounts and commissions) of approximately \$43.9 million. The notes are senior unsecured obligations, ranking equal in right of payment with all future unsecured indebtedness. The notes bear interest at a rate of 3.75%, payable semiannually in arrears each May 18 and November 18. We used approximately \$3.3 million of the proceeds to purchase U.S. government securities that were pledged to the trustee for the payment of the first four scheduled interest payments on the notes when due.

The notes are convertible, at the option of the holder, at any time prior to maturity into shares of our common stock. Upon conversion, we may, at our option, elect to deliver cash in lieu of shares of our common stock or a combination of cash and shares of common stock. Effective May 13, 2005, the conversion price of the notes was adjusted to \$2.31 per share of common stock, which is equal to a conversion rate of approximately 432.9004 shares of common stock per \$1,000 principal amount of notes. Prior to this adjustment, the conversion price applicable to the notes was \$2.81 per share of common stock, which was equal to approximately 355.8719 shares of common stock per \$1,000 principal amount of notes. The adjustment was made pursuant to the terms of the indenture governing the notes. The conversion price is subject to further adjustment under the terms of the indenture to reflect stock dividends, stock splits, issuances of rights to purchase shares of common stock and certain other events.

If we undergo certain fundamental changes (as defined in the indenture), holders of notes may require us to repurchase some or all of their notes at 100% of the principal amount plus accrued and unpaid interest. If, upon notice of certain events constituting a fundamental change, holders of the notes elect to convert the notes, we will be required to increase the number of shares issuable upon conversion by up to 72.09 shares per \$1,000 principal amount of notes. The number of additional shares, if any, will be determined by the table set forth in the indenture governing the notes. In the event of a non-stock change of control constituting a public acquirer change of control (as defined in the indenture), we may, in lieu of issuing additional shares or making an additional cash payment upon conversion as required by the indenture, elect to adjust the conversion price and the related conversion



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obligation such that the noteholders will be entitled to convert their notes into a number of shares of public acquirer common stock.

For financial accounting purposes, our contingent obligation to issue additional shares or make an additional cash payment upon conversion following a fundamental change is an embedded derivative. As of June 30, 2006, the estimated fair value of our liability under the fundamental change adjustment was not significant.

*Conexant Warrant*

In the distribution, we issued to Conexant a warrant to purchase 30 million shares of our common stock at a price of \$3.408 per share, exercisable for a period of ten years after the distribution. The warrant may be transferred or sold in whole or part at any time. The warrant contains antidilution provisions that provide for adjustment of the exercise price, and the number of shares issuable under the warrant, upon the occurrence of certain events. If we issue, or are deemed to have issued, shares of our common stock, or securities convertible into our common stock, at prices below the current market price of our common stock (as defined in the warrants) at the time of the issuance of such securities, the warrant's exercise price will be reduced and the number of shares issuable under the warrant will be increased. The amount of such adjustment, if any, will be determined pursuant to a formula specified in the warrant and will depend on the number of shares issued, the offering price and the current market price of our common stock at the time of the issuance of such securities. Adjustments to the warrant pursuant to these antidilution provisions may result in significant dilution to the interests of our existing stockholders and may adversely affect the market price of our common stock. The antidilution provisions may also limit our ability to obtain additional financing on terms favorable to us.

Moreover, we may not realize any cash proceeds from the exercise of the warrant held by Conexant. A holder of the warrant may opt for a cashless exercise of all or part of the warrant. In a cashless exercise, the holder of the warrant would make no cash payment to us and would receive a number of shares of our common stock having an aggregate value equal to the excess of the then-current market price of the shares of our common stock issuable upon exercise of the warrant over the exercise price of the warrant. Such an issuance of common stock would be immediately dilutive to the interests of other stockholders.

*Liquidity*

Our principal sources of liquidity are our existing cash balances, marketable securities and cash generated from product sales. As of June 30, 2006, our cash and cash equivalents totaled \$20.4 million and our marketable securities totaled \$23.7 million. Our working capital at June 30, 2006 was \$56.4 million.

In order to achieve profitability, or to generate positive cash flows from operations, we must achieve substantial revenue growth. Our ability to achieve the necessary revenue growth will depend on increased demand for network infrastructure equipment that incorporates our products, which in turn depends primarily on the level of capital spending by communications service providers and enterprises. Through the third quarter of fiscal 2006, we have completed a series of cost reduction actions which have improved our operating cost structure. However, these expense reductions alone, without additional revenue growth, will not make us profitable or allow us to sustain profitability if it is achieved. Moreover, some of our planned or completed cost reduction measures will not have a recurring impact in future periods, and we may be unable to sustain other past or expected future expense reductions in subsequent quarters. We expect to continue to incur significant losses and negative cash flows at least through fiscal 2006 and we may incur additional significant losses and negative cash flows in subsequent periods.

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, working capital and other financing requirements 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 or equity financing. We may also need to seek to obtain additional debt or equity financing if we experience downturns or cyclical fluctuations in our business that are more severe or longer than anticipated or if we fail to achieve anticipated revenue and expense levels. However, we cannot assure you that such financing will be available to us on favorable terms, or at all.





**Table of Contents****Contractual Obligations**

The following table summarizes the future payments we are required to make under contractual obligations as of June 30, 2006:

Contractual Obligations	Total	Payments due by period			
		<1 year	1-3 years (in millions)	3-5 years	>5 years
Long-term debt	\$ 46.0	\$	\$	\$ 46.0	\$
Interest expense on long-term debt	6.0	1.7	3.4	0.9	
Operating leases	18.2	9.3	7.6	0.7	0.6
Purchase obligations	9.3	4.0	4.4	0.9	
Total	\$ 79.5	\$ 15.0	\$ 15.4	\$ 48.5	\$ 0.6

Long-term debt consists of \$46.0 million aggregate principal amount of our Convertible Senior Notes. The notes bear interest at a rate of 3.75%, payable semiannually in arrears each May 18 and November 18, and mature on November 18, 2009. U.S. Treasury securities having an aggregate face amount of \$863,000 are pledged to the trustee for the payment of the next scheduled interest payment on the notes due in November 2006.

In March 2005, we amended and restated the Sublease with Conexant pursuant to which we lease our headquarters in Newport Beach, California. The Sublease has an initial term extending through June 2008, and we may, at our option, extend the Sublease for an additional two-year term. Rent payable under the Sublease is approximately \$4.1 million annually, subject to annual increases of 3%, plus a prorated portion of operating expenses associated with the leased property. We estimate our minimum future obligation under the Sublease at approximately \$6.6 million annually (a total of \$12.3 million over the remainder of the initial lease term), but actual costs under the Sublease will vary based upon Conexant's actual costs. In addition, each year we may elect to purchase certain services from Conexant based on a prorated portion of Conexant's actual costs.

We lease our other facilities and certain equipment under non-cancelable operating leases. The leases expire at various dates through 2014 and contain various provisions for rental adjustments, including, in certain cases, adjustments based on increases in the Consumer Price Index. The leases generally contain renewal provisions for varying periods of time. Contractual obligations under operating leases have not been reduced by anticipated rental income under noncancelable subleases totaling \$1.2 million and extending to various dates through fiscal 2008.

**Off-Balance Sheet Arrangements**

We have made guarantees and indemnities, under which we may be required to make payments to a guaranteed or indemnified party, in relation to certain transactions. In connection with the distribution, we generally assumed responsibility for all contingent liabilities and then-current and future litigation against Conexant or its subsidiaries related to the Mindspeed business. We may also be responsible for certain federal income tax liabilities under the Tax Allocation Agreement between us and Conexant, which provides that we will be responsible for certain taxes imposed on us, Conexant or Conexant stockholders. In connection with certain facility leases, we have indemnified our lessors for certain claims arising from the facility or the lease. We indemnify our directors, officers, employees and agents 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 majority of our guarantees and indemnities do not provide for any limitation of the maximum potential future payments we could be obligated to make. We have not recorded any liability for these guarantees and indemnities in the accompanying consolidated balance sheets.

**Risk Factors**

Our business, financial condition and operating results can be affected by a number of factors, including those listed below, 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 also materially and adversely affect our business, financial condition or the price of our common stock or other securities.

*We are incurring substantial operating losses, we anticipate additional future losses and we must significantly increase our revenues to become profitable.*

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We incurred a net loss of \$17.2 million for the first nine months of fiscal 2006 compared to net loss of \$62.6 million for fiscal 2005 and \$93.2 million in fiscal 2004. We expect that we will continue to incur significant losses and negative cash flows at least through fiscal 2006, and we may incur additional significant losses and negative cash flows in subsequent periods.

In order to become profitable, or to generate positive cash flows from operations, we must achieve substantial revenue growth. Our ability to achieve the necessary revenue growth will depend on increased demand for network infrastructure equipment that incorporates our products, which in turn depends primarily on the level of capital spending by communications service providers and enterprises. Through the third quarter of fiscal 2006, we have completed a series of cost reduction actions which have improved our operating cost structure. However, these expense reductions alone, without additional revenue growth, will not make us profitable or allow us to sustain profitability if it is achieved. We may not be successful in achieving the necessary revenue growth or the expected expense reductions within the anticipated time frame, or at all. Moreover, some of our planned or completed cost reduction measures will not have a recurring impact in future periods, and we may be unable to sustain other past or expected future expense reductions in subsequent quarters. Consequently, we may not achieve profitability or sustain such profitability, if achieved.

***We have substantial cash requirements to fund our operations, research and development efforts and capital expenditures. Our capital resources are limited and capital needed for our business may not be available when we need it.***

For the first nine months of fiscal 2006, our net cash used in operating activities was \$14.4 million compared to net cash used in operating activities of \$22.8 million for the first nine months of fiscal 2005. Our net cash used in operating activities was \$30.2 million for fiscal 2005 and \$43.2 million for fiscal 2004. Our principal sources of liquidity are our existing cash balances, marketable securities and cash generated from product sales. As of June 30, 2006, our cash and cash equivalents totaled \$20.4 million and our marketable securities totaled \$23.7 million. We believe that our existing sources of liquidity will be sufficient to fund our operations, research and development efforts, anticipated capital expenditures, 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 if we continue to incur operating losses and negative cash flows in the future, we may need to reduce further our operating costs or obtain alternate sources of financing, or both. We may not have access to additional sources of capital on favorable terms or at all. If we raise additional funds through the issuance of equity, equity-based or debt securities, such securities may have rights, preferences or privileges senior to those of our common stock and our stockholders may experience dilution of their ownership interests.

***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 in general, and in our business in particular. Periods of industry downturns have been characterized by diminished product demand, production overcapacity, high inventory levels and accelerated erosion of average selling prices. These factors have caused substantial fluctuations in our revenues and our results of operations in the past and we may experience similar fluctuations in our business in the future.

***Our operating results are subject to substantial quarterly and annual fluctuations.***

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

fluctuations in the levels of component inventories held by our customers and changes in our customers inventory management practices;

shifts in our product mix and the effect of maturing products;

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availability and cost of products from our suppliers;

the gain or loss of significant customers;

market acceptance of our products and our customers' products;

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

the timing and extent of product development costs;

new product and technology introductions by us or our competitors;

fluctuations in manufacturing yields;

significant warranty claims, including those not covered by our suppliers;

intellectual property disputes; and

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

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, they could materially and adversely affect the price of our common stock.

***We are entirely dependent upon third parties for the manufacture of our products and are vulnerable to their capacity constraints during times of increasing demand for semiconductor products.***

We are entirely dependent upon outside wafer fabrication facilities, known as foundries, for wafer fabrication services. Our principal suppliers of wafer fabrication services are TSMC and Jazz. We are also dependent upon third parties, including Amkor, for the assembly and testing of all of our products. Under our fabless business model, our long-term revenue growth is dependent on our ability to obtain sufficient external manufacturing capacity, including wafer production capacity. Periods of upturns in the semiconductor industry may be characterized by rapid increases in demand and a shortage of capacity for wafer fabrication and assembly and test services.

The risks associated with our reliance on third parties for manufacturing services include:

the lack of assured supply, potential shortages and higher prices;

increased lead times;

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

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

Our standard lead time, or the time required to manufacture our products (including wafer fabrication, assembly and testing) is typically 12 to 16 weeks. During periods of manufacturing capacity shortages, the foundries and other suppliers on whom we rely may devote their limited capacity to fulfill the production requirements of other clients that are larger than we are, or who have superior contractual rights to enforce manufacture of their products, including to the exclusion of producing our products.

Additionally, if we are required to seek alternative foundries or assembly and test service providers, we would be subject to longer lead times, indeterminate delivery schedules and increased manufacturing costs, including costs to find and qualify acceptable suppliers. For example, if we choose to use a new foundry, the qualification process may take as long as six months over the standard lead time before we can begin shipping products from the new foundry. Wafer fabrication processes are subject to obsolescence, and foundries may discontinue a wafer fabrication process used for certain of our products. In such event, we generally offer our customers a "last-time buy" program to satisfy

their anticipated requirements for our products. The unanticipated discontinuation of a wafer fabrication process on which we rely may adversely affect our revenues and our customer relationships.

The foundries and other suppliers on whom we rely may experience financial difficulties or suffer disruptions in their operations due to causes beyond our control, including labor strikes, work stoppages, electrical power outages, fire, earthquake, flooding or other natural disasters. Certain of our suppliers' manufacturing facilities are located

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near major earthquake fault lines in the Asia-Pacific region and California. In the event of a disruption of the operations of one or more of our suppliers, we may not have an alternate source immediately available. Such an event could cause significant delays in shipments until we could shift the products from an affected facility or supplier to another facility or supplier. The manufacturing processes we rely on are specialized and are available from a limited number of suppliers. Alternate sources of manufacturing capacity, particularly wafer production capacity, may not be available to us on a timely basis. Even if alternate manufacturing capacity is available, we may not be able to obtain it on favorable terms, or at all. Difficulties or delays in securing an adequate supply of our products on favorable terms, or at all, could impair our ability to meet our customers' requirements 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 basis. Moreover, lower than anticipated manufacturing yields may adversely affect our cost of goods sold and our results of operations.

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

The communications semiconductor industry in general, and the markets in which we compete in particular, are intensely competitive. We compete worldwide with a number of U.S. and international semiconductor manufacturers that are both larger and smaller than we are 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.

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

stronger financial position and liquidity;

longer presence in key markets;

greater name recognition;

more secure supply chain;

access to larger customer bases; and

significantly greater 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. Moreover, we have incurred substantial operating losses, and we anticipate future losses. We believe that financial stability of suppliers is an important consideration in our customers' purchasing decisions. If our OEM customers perceive that we lack adequate financial stability, they may choose semiconductor suppliers that they believe have a stronger financial position or liquidity.

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 may not be able to compete successfully against current and potential competitors.

***Our success depends on our ability to develop competitive new products in a timely manner.***

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;





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our ability to accurately define new products;

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

Research and development projects may experience unanticipated delays related to our internal design efforts. New product development also requires the production of photomask sets and the production and testing of sample devices. In the event we experience delays in obtaining these services from the wafer fabrication and assembly and test vendors on whom we rely, our product introductions may be delayed and our revenues and results of operations may be adversely affected.

***If we are not able to keep abreast of the rapid technological changes in our markets, our products could become obsolete.***

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;

rapid changes in customer requirements;

frequent new product introductions and enhancements;

declining prices over the life cycle of products; and

evolving industry standards.

Our products could become obsolete sooner than we expect because of faster than anticipated, or unanticipated, changes in one or more of the technologies related to our products. The introduction of new technology representing a substantial advance over current technology could adversely affect demand for our existing products. Currently accepted industry standards are also subject to change, which may also contribute to the obsolescence of our products. If we are unable to develop and introduce new or enhanced products in a timely manner, our business may be adversely affected.

***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 substantial portion of our products through distributors, some of whom have a right to return unsold products to us. Sales to distributors accounted for approximately 47% and 49%, respectively, of our net revenues for fiscal 2005 and the first nine months of fiscal 2006.

Because of the significant lead times for wafer fabrication and assembly and test services, we routinely purchase inventory based on estimates of end-market demand for our customers' products, which may be subject to dramatic changes and 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

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write-downs of inventory. Conversely, if we fail to anticipate inventory needs we may be unable to fulfill demand for our products, resulting in a loss of potential revenue.

***If network infrastructure OEMs 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 network infrastructure OEMs to select our products from among alternative offerings to be designed into their equipment. We may be unable to achieve these design wins. Without 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 is 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 and we may be unable to convert design wins into actual sales. 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.

***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 generally 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. These lengthy periods also increase 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 any revenues from new products. We may never generate the anticipated revenues if our customers cancel or change their product plans.

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

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 against technologies that are important to our business. The resolution or compromise of any litigation or other legal process to enforce such alleged third party rights, including claims arising through our contractual indemnification of our customers, or claims challenging the validity of our patents, regardless of its merit or resolution, could be costly and divert the efforts and attention of our management and technical personnel. We may not prevail in any such litigation or other legal process or we may compromise or settle such claims because of the complex technical issues and inherent uncertainties in intellectual property disputes and the significant expense in defending such claims. If litigation or other legal process results in adverse rulings we could be required to:

pay substantial damages for past, present and future use of the infringing technology;

cease the manufacture, use or sale of infringing products;

discontinue the use of infringing technology;

expend significant resources to develop non-infringing technology;

pay substantial damages to our customers or end users to discontinue use or replace infringing technology with non-infringing technology;

license technology from the third party claiming infringement, which license may not be available on commercially reasonable terms, or at all; or

relinquish intellectual property rights associated with one or more of our patent claims, if such claims are held invalid or otherwise unenforceable.

In connection with the distribution, we generally assumed responsibility for all contingent liabilities and litigation against Conexant or its subsidiaries related to the Mindspeed business.

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***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 employee and third-party nondisclosure and confidentiality agreements and other methods, to protect our proprietary technologies and processes. We may be required to engage in litigation to enforce or protect our intellectual property rights, which may require us to expend significant resources and to divert the efforts and attention of our management from our business operations. In particular:

the steps we take to prevent misappropriation or infringement of our intellectual property may not be successful;

any existing or future patents may be challenged, invalidated or circumvented; or

the measures described above may not provide meaningful protection.

Despite the preventive measures and precautions that we take, a third party could copy or otherwise obtain and use our technology without authorization, develop similar technology independently or design around our patents. In addition, effective patent, copyright, trademark and trade secret protection may be unavailable or limited in certain countries.

***The complexity of our products may lead to errors, defects and bugs, which could subject us to significant costs or damages and adversely affect market acceptance of our products.***

Although we, our customers and our suppliers rigorously test our products, our products are complex and may contain errors, defects or bugs when first introduced or as new versions are released. We have in the past experienced, and may in the future experience, errors, defects and bugs. If any of our products contain production defects or reliability, quality or compatibility problems that are significant to our customers, our reputation may be damaged and customers may be reluctant to buy our products, which could adversely affect our ability to retain existing customers and attract new customers. In addition, these defects or bugs could interrupt or delay sales of affected products to our customers, which could adversely affect our results of operations.

If defects or bugs are discovered after commencement of commercial production of a new product, we may be required to make significant expenditures of capital and other resources to resolve the problems. This could result in significant additional development costs and the diversion of technical and other resources from our other development efforts. We could also incur significant costs to repair or replace defective products and we could be subject to claims for damages by our customers or others against us. These costs or damages could have a material adverse effect on our financial condition and results of operations.

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

Our future success depends on our ability to attract, retain and motivate qualified personnel, including executive officers and other key management, technical and support personnel. As the source of our technological and product innovations, our key technical personnel represent a significant asset. The competition for such personnel can be intense in the semiconductor industry. We may not be able to attract and retain qualified management and other personnel necessary for the design, development, sale and support of our products.

In periods of poor operating performance, we have experienced, and may experience in the future, particular difficulty attracting and retaining key personnel. If we are not successful in assuring our employees of our financial stability and our prospects for success, our employees may seek other employment, which may materially adversely affect our business. Moreover, our recent expense reduction and restructuring initiatives, including a series of worldwide workforce reductions, have significantly reduced the number of our technical employees. The loss of the services of one or more of our key employees, including Raouf Y. Halim, our 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.

Approximately 10% of our engineers are foreign nationals working in the United States under visas. The visas held by many of our employees permit qualified foreign nationals working in specialty occupations, such as certain categories of engineers, to reside in the United States during their employment. The number of new visas approved



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each year may be limited and may restrict our ability to hire additional qualified technical employees. In addition, immigration policies are subject to change, and these policies have generally become more stringent since the events of September 11, 2001. Any additional significant changes in immigration laws, rules or regulations may further restrict our ability to retain or hire technical personnel.

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

For fiscal 2005 and the first nine months of fiscal 2006, approximately 71% and 69%, respectively, of our net revenues were from customers located outside the United States, primarily in the Asia-Pacific region and Europe. In addition, we have design centers, and rely on suppliers, located outside the United States, including foundries and assembly and test service providers located in the Asia-Pacific region. Our international sales and operations are subject to a number of risks inherent in selling and operating abroad which could adversely affect our ability to increase or maintain our foreign sales. These include, but are not limited to, risks regarding:

currency exchange rate fluctuations;

local economic and political conditions;

disruptions of capital and trading markets;

accounts receivable collection and longer payment cycles;

difficulties in staffing and managing foreign operations;

potential hostilities and changes in diplomatic and trade relationships;

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

changes in legal or regulatory requirements;

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.

From time to time we may enter into foreign currency forward exchange contracts to mitigate the 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. Our financial condition and results of operations could be adversely affected by currency fluctuations.

***We may make business acquisitions or investments, which involve significant risk.***

We may from time to time make acquisitions, enter into alliances or make investments in other businesses to complement our existing product offerings, augment our market coverage or enhance our technological capabilities. However, any such transactions could result in:

issuances of equity securities dilutive to our existing stockholders;



the incurrence of substantial debt and assumption of unknown liabilities;

large one-time write-offs;

amortization expenses related to intangible assets;

the diversion of management's attention from other business concerns; and

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the potential loss of key employees from the acquired business.

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.

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.

***The price of our common stock may fluctuate significantly.***

The price of our common stock is volatile and may fluctuate significantly. There can be no assurance as to the prices at which our common stock will trade or that an active trading market in our common stock will be sustained in the future. The market price at which our common stock trades may be influenced by many factors, including:

our operating and financial performance and prospects, including our ability to achieve profitability within the forecasted time period and sustain profitability, if achieved;

the depth and liquidity of the market for our common stock;

investor perception of us and the industry in which we operate;

the level of research coverage of our common stock;

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 may in the future experience, 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. If our common stock trades below \$1.00 for 30 consecutive trading days, or if we otherwise do not meet the requirements for continued quotation on The Nasdaq Stock Market, our common stock could be delisted, which would adversely affect the ability of investors to sell shares of our common stock and could otherwise adversely affect our business.

***Substantial sales of the shares of our common stock issuable upon conversion of our convertible senior notes or exercise of the warrant issued to Conexant could adversely affect our stock price or our ability to raise additional financing in the public capital markets.***

Conexant holds a warrant to acquire 30 million shares of our common stock at a price of \$3.408 per share, exercisable through June 27, 2013, representing approximately 16% of our outstanding common stock on a fully diluted basis. The warrant may be transferred or sold in whole or part at any time. If Conexant sells the warrant or if Conexant or a transferee of the warrant exercises the warrant and sells a substantial number of shares of our common stock in the future, or if investors perceive that these sales may occur, the market price of our common stock could decline or market demand for our common stock could be sharply reduced. As of June 30, 2006, we have \$46.0 million principal amount of convertible senior notes outstanding. These notes are convertible at any time, at the option of the holder, into approximately 432,9004 shares of common stock per \$1,000 principal amount of notes or an aggregate of approximately 19.9 million shares of our common stock. The conversion of the notes and subsequent sale of a substantial number of shares of our common stock could also adversely affect demand for, and the market price of, our common stock. Each of these transactions could adversely affect our ability to raise additional financing by issuing equity or equity-based securities in the public capital markets.

***Antidilution and other provisions in the warrant issued to Conexant may also adversely affect our stock price or our ability to raise additional financing.***

The warrant issued to Conexant contains antidilution provisions that provide for adjustment of the warrant's exercise price, and the number of shares issuable under the warrant, upon the occurrence of certain events. If we issue, or are

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deemed to have issued, shares of our common stock, or securities convertible into our common stock, at prices below the current market price of our common stock (as defined in the warrant) at the time of the issuance of such securities, the warrant's exercise price will be reduced and the number of shares issuable under the warrant will be increased. The amount of such adjustment, if any, will be determined pursuant to a formula specified in the warrant and will depend on the number of shares issued, the offering price and the current market price of our common stock at the time of the issuance of such securities. Adjustments to the warrant pursuant to these antidilution provisions may result in significant dilution to the interests of our existing stockholders and may adversely affect the market price of our common stock. The antidilution provisions may also limit our ability to obtain additional financing on terms favorable to us.

Moreover, we may not realize any cash proceeds from the exercise of the warrant held by Conexant. A holder of the warrant may opt for a cashless exercise of all or part of the warrant. In a cashless exercise, the holder of the warrant would make no cash payment to us, and would receive a number of shares of our common stock having an aggregate value equal to the excess of the then-current market price of the shares of our common stock issuable upon exercise of the warrant over the exercise price of the warrant. Such an issuance of common stock would be immediately dilutive to the interests of other stockholders.

***Some of our directors and executive officers may have potential conflicts of interest because of their positions with Conexant or their ownership of Conexant common stock.***

Some of our directors are Conexant directors, and our non-executive chairman of the board is chairman of the board and chief executive officer of Conexant. Several of our directors and executive officers own Conexant common stock and hold options to purchase Conexant common stock. Service on our board of directors and as a director or officer of Conexant, or ownership of Conexant common stock by our directors and executive officers, could create, or appear to create, potential conflicts of interest when directors and officers are faced with decisions that could have different implications for us and Conexant. For example, potential conflicts could arise in connection with decisions involving the warrant to purchase our common stock issued to Conexant, or other agreements entered into between us and Conexant in connection with the distribution.

Our restated certificate of incorporation includes provisions relating to the allocation of business opportunities that may be suitable for both us and Conexant based on the relationship to the companies of the individual to whom the opportunity is presented and the method by which it was presented and also includes provisions limiting challenges to the enforceability of contracts between us and Conexant.

We may have difficulty resolving any potential conflicts of interest with Conexant, and even if we do, the resolution may be less favorable than if we were dealing with an entirely unrelated third party.

***Provisions in our organizational documents and rights plan and Delaware law will make it more difficult for someone to acquire control of us.***

Our restated certificate of incorporation, our amended and restated bylaws, our amended rights agreement 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 amended and restated bylaws 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 stockholders;

- a prohibition on stockholder action by written consent;

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

- 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 amended bylaws;

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

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a fair price provision.

Our rights agreement gives our stockholders 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 amended bylaws, Section 203 of the Delaware General Corporation Law generally provides that a corporation shall not engage in any business combination with any interested stockholder during the three-year period following the time that such stockholder becomes an interested stockholder, unless a majority of the directors then in office approves either the business combination or the transaction that results in the stockholder becoming an interested stockholder or specified stockholder approval requirements are met.

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

Our cash and cash equivalents consist of demand deposits and highly-liquid money market funds. Our marketable securities principally consist of auction rate securities whose interest rates reset periodically (generally every seven or twenty-eight days) and U.S. Treasury securities having maturities of less than twelve months. Our main investment objectives are the preservation of investment capital and the maximization of after-tax returns on our investment portfolio. Consequently, we invest in securities that meet high credit quality standards and we limit the amount of our credit exposure to any one issuer. We do not use derivative instruments for speculative or investment purposes.

*Interest Rate Risk*

Our cash and cash equivalents and marketable securities are not subject to significant interest rate risk due to the short maturities or variable interest rate characteristics of these instruments. As of June 30, 2006, the carrying value of our cash and cash equivalents and marketable securities approximates fair value.

Our long-term debt consists of convertible senior notes which bear interest at a fixed rate of 3.75%. Consequently, our results of operations and cash flows are not subject to any significant interest rate risk relating to our long-term debt.

*Foreign Currency Exchange Rate Risk*

We transact business in various foreign currencies and we face foreign currency exchange rate risk on assets and liabilities that are denominated in foreign currencies. The majority of our foreign exchange risks are not hedged; however, from time to time, we may utilize foreign currency forward exchange contracts to hedge a portion of our exposure to foreign currency exchange rate risk. These hedging transactions are intended to offset the gains and losses we experience on foreign currency transactions with gains and losses on the forward contracts, so as to mitigate our overall risk of foreign exchange gains and losses. We do not enter into forward contracts for speculative or trading purposes. At June 30, 2006, we held no foreign currency forward exchange contracts. Based on our overall currency rate exposure at June 30, 2006, a 10% change in currency rates would not have a material effect on our consolidated financial position, results of operations or cash flows.

**ITEM 4. CONTROLS AND PROCEDURES**

**Evaluation of Disclosure Controls and Procedures**

Under the supervision and with the participation of our management, including our Chief Executive Officer and our Chief Financial Officer, we have evaluated the effectiveness of the design and operation of our disclosure controls and procedures as of June 30, 2006. Disclosure controls and procedures are defined under SEC rules as controls and other procedures that are designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within required time periods. Based upon that evaluation, our Chief Executive Officer and our Chief Financial Officer have concluded that these disclosure controls and procedures were effective.

**Changes in Internal Control over Financial Reporting**

There were no changes in our internal control over financial reporting during the fiscal quarter ended June 30, 2006 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**Table of Contents****PART II. OTHER INFORMATION****ITEM 1A. RISK FACTORS**

The requirements of this Item 1A are not applicable to our company until we have filed our next Annual Report on Form 10-K containing the risk factors required to be disclosed under Part I, Item 1A therein. For a discussion of the risks that could affect our business, financial condition and operating results, please see the discussion under the heading "Risk Factors" in Part I, Item 2. "Management's Discussion and Analysis of Financial Condition and Results of Operations" in this Report.

**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS****Issuer Purchases of Equity Securities**

	<b>Total Number of Shares (or Units)  Purchased</b>	<b>Average Price Paid per Share  (or Unit)</b>	<b>Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs</b>	<b>Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs</b>
April 1, 2006 to April 28, 2006	10,368 (a)	\$ 3.98		
April 29, 2006 to May 26, 2006	2,291 (a)	\$ 3.53		
May 27, 2006 to June 30, 2006	2,528 (a)	\$ 2.74		
	15,187	\$ 3.70		

(a) Represents shares of our common stock withheld from, or delivered by, employees in order to satisfy applicable tax withholding obligations in connection with the vesting of restricted stock. These repurchases were not made pursuant to any publicly announced plan or program.



**ITEM 5. OTHER INFORMATION**

The following disclosure would otherwise be filed on Form 8-K under the heading Item 1.01. Entry Into a Material Definitive Agreement :

(a) On June 26, 2006, we entered into a confidential severance agreement and general release with Danny Shamlou, senior vice president and general manager, transmission solutions and corporate chief technical officer.

The severance agreement provides that we will: (i) pay Mr. Shamlou severance at a rate equal to his current salary rate of \$5,769 per week until April 30, 2007; (ii) continue paying Mr. Shamlou s medical, dental, vision, life insurance, executive physical, health club and financial counseling benefits until April 30, 2008; and (iii) provide Mr. Shamlou with outplacement assistance at our expense.

The severance agreement provides that Mr. Shamlou will be placed on unpaid leave from May 1, 2007 through April 30, 2008, at which time all unvested stock options and restricted stock awards shall expire. Any vested stock options as of April 30, 2008, will be exercisable for a period of three months thereafter. In addition, all of Mr. Shamlou s fiscal year 2006 personal achievement restricted stock award will be deemed earned.

The severance agreement also contains Mr. Shamlou s release of claims, including employment-related claims. Under the severance agreement, Mr. Shamlou has agreed to a limited non-competition provision and agreed not to solicit our employees for a period ending on April 30, 2009.

The foregoing summary is not intended to be complete and is qualified in its entirety by reference to the severance agreement, which is filed as Exhibit 10.1 to this Report.

(b) On August 4, 2006, we entered into a change of control employment agreement with Gerald J. Hamilton, senior vice president, worldwide sales, which is substantially identical to the form of agreement filed as Exhibit 10.8.1 to our registration statement on Form 10 (File No. 1-31650) that was filed with the Securities and Exchange Commission on May 13, 2003.

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The employment agreement becomes effective upon a change of control of our company and provides for the continuing employment of Mr. Hamilton after the change of control on terms and conditions no less favorable than those in effect before the change of control. If we terminate Mr. Hamilton's employment without cause or if Mr. Hamilton terminates his own employment for good reason, as defined in the employment agreement, Mr. Hamilton is entitled to severance benefits equal to two times his annual compensation, including bonus and continuation of certain benefits for two years. Mr. Hamilton is entitled to an additional payment, if necessary, to make him whole as a result of any excise tax imposed on certain change of control payments, subject to some minor adjustments.

For purposes of the employment agreement, a change of control is defined generally as:

the acquisition by any individual, entity or group of beneficial ownership of 20% or more of either the then outstanding shares of our common stock or the combined voting power of the then outstanding voting securities entitled to vote generally in the election of directors;

a change in the composition of a majority of the board, which is not supported by the current board;

a major corporate transaction, such as a reorganization, merger or consolidation or sale or other disposition of all or substantially all of our assets, which results in a change in the majority of the board or of more than 60% of our stockholders; or

approval by our stockholders of the complete liquidation or dissolution of our company.

The foregoing summary of the employment agreement is qualified in its entirety by reference to Exhibit 10.8.1 to our registration statement on Form 10 (File No. 1-31650) that was filed with the Securities and Exchange Commission on May 13, 2003.

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**ITEM 6. EXHIBITS**

- 3.1 Restated Certificate of Incorporation of the Registrant, filed as Exhibit 4.1 to the Registrant's Registration Statement on Form S-3 (Registration Statement No. 333-106146), is incorporated herein by reference.
- 3.2 Amended and Restated Bylaws of the Registrant, filed as Exhibit 3.2 to the Registrant's Annual Report on Form 10-K for the year ended September 30, 2005, is incorporated herein by reference.
- 4.1 Specimen certificate for the Registrant's Common Stock, par value \$.01 per share, filed as Exhibit 4.1 to the Registrant's Registration Statement on Form 10 (File No. 1-31650), is incorporated herein by reference.
- 4.2 Rights Agreement dated as of June 26, 2003, by and between the Registrant and Mellon Investor Services LLC, as Rights Agent, filed as Exhibit 4.1 to the Registrant's Current Report on Form 8-K dated July 1, 2003, is incorporated herein by reference.
- 4.3 First Amendment to Rights Agreement, dated as of December 6, 2004, by and between the Registrant and Mellon Investor Services LLC, filed as Exhibit 4.4 to the Registrant's Current Report on Form 8-K dated December 2, 2004, is incorporated herein by reference.
- 4.4 Common Stock Purchase Warrant dated June 27, 2003, filed as Exhibit 4.5 to the Registrant's Registration Statement on Form S-3 (Registration Statement No. 333-109523), is incorporated herein by reference.
- 4.5 Registration Rights Agreement dated as of June 27, 2003, by and between the Registrant and Conexant Systems, Inc., filed as Exhibit 4.6 to the Registrant's Registration Statement on Form S-3 (Registration Statement No. 333-109523), is incorporated herein by reference.
- 4.6 Credit Agreement Warrant dated June 27, 2003, issued by the Registrant to Conexant Systems, Inc., filed as Exhibit 4.5 to the Registrant's Registration Statement on Form S-3 (Registration Statement No. 333-109525), is incorporated herein by reference.
- 4.7 Registration Rights Agreement dated as of June 27, 2003 by and between the Registrant and Conexant Systems, Inc., filed as Exhibit 4.6 to the Registrant's Registration Statement on Form S-3 (Registration Statement No. 333-109525), is incorporated herein by reference.
- 4.8 Indenture, dated as of December 8, 2004, between the Registrant and Wells Fargo Bank, N.A., filed as Exhibit 4.1 to the Registrant's Current Report on Form 8-K dated December 2, 2004, is incorporated herein by reference.
- 4.9 Form of 3.75% Convertible Senior Notes due 2009, attached as Exhibit A to the Indenture (Exhibit 4.8 hereto), is incorporated herein by reference.
- 4.10 Registration Rights Agreement, dated as of December 8, 2004, by and between the Registrant and Lehman Brothers Inc., filed as Exhibit 4.3 to the Registrant's Current Report on Form 8-K dated December 2, 2004, is incorporated herein by reference.
- \* 10.1 Confidential Severance Agreement and General Release, dated June 26, 2006, by and between Danny Shamlou and the Registrant
- \* 10.2

Schedule identifying parties to and terms of agreements with the Registrant substantially identical to the Employment Agreement filed as Exhibit 10.8.1 to the Registrant's Registration Statement on Form 10 (File No. 1-31650).

12.1 Statement re: Computation of Ratios.

31.1 Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

31.2 Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

32.1 Certification of Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

32.2 Certification of Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

\* Management contract or compensatory plan or arrangement.

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.

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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.

MINDSPEED TECHNOLOGIES, INC.  
(Registrant)

Date: August 8, 2006

By /s/ Simon Biddiscombe  
Simon Biddiscombe  
Senior Vice President, Chief Financial  
Officer, Secretary and Treasurer  
(principal financial officer)  
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