

MINDSPEED TECHNOLOGIES, INC

Form 10-K

November 29, 2006

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

**Form 10-K**

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

**For the fiscal year ended September 30, 2006**

**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**

*(Address of principal executive offices)*

**92660-3095**

*(Zip code)*

**Registrant's telephone number, including area code:**

**(949) 579-3000**

**Securities registered pursuant to Section 12(b) of the Act:**

**Common Stock \$0.01 par value per share  
(including associated Preferred Share Purchase Rights)**  
*(Title of Each Class)*

**The NASDAQ Stock Market LLC**  
*(Name of Each Exchange on Which Registered)*

**Securities registered pursuant to Section 12(g) of the Act:**

**None**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes  No

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer.

Large Accelerated Filer  Accelerated Filer  Non-accelerated Filer

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

The aggregate market value of the Registrant's voting and non-voting stock held by non-affiliates of the Registrant as of the end of its most recently completed second fiscal quarter was approximately \$427.4 million. Shares held by each officer and director and each person owning more than 10% of the outstanding voting and non-voting stock have been excluded from this calculation because such persons may be deemed to be affiliates of the Registrant. This determination of potential affiliate status is not necessarily a conclusive determination for other purposes. Shares held include shares of which certain of such persons disclaim beneficial ownership.

The number of outstanding shares of the Registrant's Common Stock as of October 27, 2006 was 110,792,184.

### **Documents Incorporated by Reference**

Portions of the Registrant's Proxy Statement for the 2007 Annual Meeting of Stockholders, to be filed pursuant to Regulation 14A within 120 days after the end of the 2006 fiscal year, are incorporated by reference into Part III of this Form 10-K.

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**FORWARD-LOOKING STATEMENTS**

This Annual Report on Form 10-K 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 Annual Report on Form 10-K, 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 Annual Report on Form 10-K include, without limitation, statements regarding:

our competitive advantages;

the benefits of a fabless operation;

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 importance of software drivers and application software;

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, the build-out of networks in developing countries, and the increased outsourcing of component requirements;

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

the growth rate for products in the enterprise, network access and metro service areas and our position to increase market share;

the focus of our research and development efforts on certain products, including 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;

competition and the principal competitive factors for semiconductor suppliers, including time to market, product quality, reliability and performance, customer support, price and total system cost, new product innovation and compliance with industry standards;

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

our investments in research and development;

the value of our intellectual property;

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

the importance of attracting and retaining highly skilled, dedicated personnel;

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 importance of providing comprehensive product service and support;

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

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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;

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 expectation that our provision for income taxes for fiscal 2007 will principally consist of income taxes related to our foreign operations;

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

our restructuring plans, including expected workforce reductions and facilities closures, the expected cost savings under our restructuring plans and the uses of those savings, the timing and amount of payments to complete the actions, the source of funds for such payments, the impact on our liquidity and the resulting decreases in our research and development and selling, general and administrative expenses, and the amounts of future charges to complete our restructuring plans;

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;

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

our belief that the financial stability of suppliers is an important consideration in our customers' purchasing decisions;

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:

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;

availability and terms of capital needed for our business;

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

our ability to successfully and cost effectively establish and manage operations in jurisdictions with low cost structures;

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;



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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 Annual Report on Form 10-K are subject to additional risks and uncertainties, including those set forth in Item 1A 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 Annual Report on Form 10-K, references made to the years ended September 30, 2006, September 30, 2005 and September 30, 2004 relate to the actual fiscal years ended September 29, 2006, September 30, 2005, and October 1, 2004, respectively.

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**PART I**

**Item 1. *Business***

Mindspeed Technologies, Inc. (we or Mindspeed) designs, develops and sells 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 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, digital loop carrier equipment, IP private branch exchanges (PBXs) and optical modules. Service providers and enterprises use this equipment for the processing, transmission and switching of high-speed voice, data and video traffic, including advanced services such as voice over Internet protocol (VoIP), within different segments of the communications network. Our customers include Alcatel Data Networks, S.A., Cisco Systems, Inc., Huawei Technologies Co., McData Corporation, Mitsubishi Electric Corporation, Siemens A.G. and Zhongxing Telecom Equipment Corp. (ZTE).

We believe the breadth of our product portfolio, combined with more than three decades of experience in semiconductor hardware, software and communications systems engineering, provide us with a competitive advantage. We have proven expertise in signal, packet and transmission processing technologies, which are critical core competencies for successfully defining, designing and implementing advanced semiconductor products for next-generation network infrastructure equipment. We seek to cultivate close relationships with leading network infrastructure OEMs to understand emerging markets, technologies and standards. We focus our research and development efforts on applications in the segments of the telecommunications network which we believe offer the most attractive growth prospects. Our business is fabless, which means we outsource all of our manufacturing needs, and we do not own or operate any semiconductor manufacturing facilities. We believe being fabless allows us to minimize operating infrastructure and capital expenditures, maintain operational flexibility and focus our resources on the design, development and marketing of our products – the highest value-creation elements of our business model.

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

Mindspeed was originally incorporated in Delaware in 2001 as a wholly owned subsidiary of Conexant Systems, Inc. ( Conexant ). On June 27, 2003, Conexant completed the distribution to Conexant stockholders of all outstanding shares of common stock of Mindspeed (the distribution). In the distribution, each Conexant stockholder received one share of our common stock (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 Global 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. In connection with the Distribution, we and Conexant also entered into a Credit Agreement (terminated December 2004), an Employee Matters Agreement, a Tax Allocation Agreement, a Transition Services Agreement and a Sublease.

**Industry Overview**

Communications semiconductor products are a critical part of network infrastructure equipment. Network infrastructure OEMs require advanced communications semiconductor products such as digital signal processors, transceivers, framers, packet and cell processors and switching solutions that are highly optimized for the equipment employed by their customers. We seek to provide semiconductor products that enable network

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infrastructure OEMs to meet the needs of their service provider and enterprise customers in terms of system performance, functionality and time-to-market.

### ***Addressed Markets***

Our semiconductor products are primarily focused on network infrastructure equipment applications in three segments of the broadly defined communications network: enterprise networks; network access service areas; and metropolitan area networks. The type and complexity of network infrastructure equipment used in these segments continues to expand, driven by the need for the processing, transmission and switching of digital voice, data and video traffic over multiple communication media, at numerous transmission data rates and employing different protocols. We also offer a limited number of products used in wide-area or long-haul networks.

*Enterprise* networks include equipment that is deployed primarily in the offices of commercial enterprises for voice and data communications and access to outside networks. An enterprise network may be comprised of many local area networks, as well as client workstations, centralized database management systems, storage area networks and other components. In enterprise networks, communications semiconductors facilitate the processing and transmission of voice, data and video traffic in converged IP networks that are replacing the traditional separate telephone, data and video conferencing networks. Typical network infrastructure equipment found in enterprise networks that use our products include voice gateways, IP PBXs, storage area network (SAN) routers and director class switches. In addition, a major trend in the broadcast video market is the switch from analog to digital television transmission and the conversion from standard-definition television services to high-definition television (HDTV) services featuring more detailed images and digital surround sound. We offer a family of broadcast-video products optimized for high-speed HDTV routing and production switcher applications.

*Network Access* service areas of the telecommunications network refer to the last mile of a telecommunications or cable service provider's physical network (including copper, fiber optic or wireless transmission) and the network infrastructure equipment that connects end-users, typically located at a business or residence, with metropolitan area and wide-area networks. For this portion of the network, infrastructure equipment requires semiconductors that enable reliable, high-speed connectivity capable of aggregating or disaggregating and transporting multiple forms of voice, data and video traffic. In addition, communications semiconductors must accommodate multiple transmission standards and communications protocols to provide a bridge between dissimilar access networks, for example, connecting wireless base station equipment to a wireline network. Typical network infrastructure equipment found at the edge of the network access service area that use our products include remote access concentrators, digital subscriber line (DSL) access multiplexers, mixed-media gateways, wireless base stations, digital loop carrier equipment and optical line termination and media converters.

*Metropolitan Area Networks*, or metro, service areas of the telecommunications network refer to the portion of a service provider's physical network that enables high-speed communications within a city or a larger regional area. In addition, it provides the communications link between network access service areas and the fiber optic-based, wide-area network. For metro equipment applications, communications semiconductors provide transmission and processing capabilities, as well as information segmentation and classification, and routing and switching functionality, to support high-speed traffic from multiple sources employing different transmission standards and communications protocols. These functions require signal conversion, signal processing and packet processing expertise to support the design and development of highly integrated mixed-signal devices combining analog and digital functions with communications protocols and application software. Typical network infrastructure equipment found in metro service areas that use our products include add-drop multiplexers, switches, high-speed routers, digital cross-connect systems, optical edge devices and multiservice provisioning platforms.

The telecommunications network, including the Internet, has evolved into a complex, hybrid series of digital and optical networks that connect individuals and businesses globally. These new larger bandwidth, data-centric networks integrate voice, data and video traffic, operate over both wired and wireless media, link existing voice and data networks and cross traditional enterprise, network access, metro and long haul service area boundaries. Network infrastructure OEMs are designing faster, more intelligent and more complex equipment to satisfy the needs of the service providers as they continue to expand their network coverage and service offerings while upgrading and connecting or integrating existing networks of disparate types. In this demanding environment, we

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believe network infrastructure OEMs select as their strategic partners communications semiconductor suppliers who can deliver advanced products that provide increased functionality, lower total system cost and support for a variety of communications media, operating speeds and protocols.

### ***The Mindspeed Approach***

We believe the breadth of our product portfolio, combined with our expertise in semiconductor hardware, software and communications systems engineering, provide us with a competitive advantage in designing and selling our products to leading network infrastructure OEMs.

We have proven expertise in signal, packet and transmission processing technologies. Signal processing involves both signal conversion and digital signal processing techniques that convert and compress voice, data and video between analog and digital representations. Packet processing involves bundling or segmenting information traffic using standard protocols such as IP or asynchronous transfer mode (ATM) and enables sharing of transmission bandwidth across a given communication medium. Transmission processing involves the transport and receipt of voice, data and video traffic across copper wire and optical fiber communications media.

These core technology competencies are critical for developing semiconductor networking solutions that enable the processing, transmission and switching of high-speed voice, data and video traffic, employing multiple communications protocols, across disparate communications networks. Our core technology competencies are the foundation for developing our:

- semiconductor device architectures, including digital signal processors, mixed signal devices and programmable protocol engines, as well as analog signal processing capabilities;

- highly optimized signal processing algorithms and communications protocols, which we implement in semiconductor devices; and

- critical software drivers and application software to perform signal, packet and transmission processing tasks.

We believe the software drivers and application software are an increasingly important part of the semiconductor networking solutions we offer to OEMs.

### ***Increasing Demand for Communications Semiconductors***

We believe the market for network infrastructure equipment in general, and for communications semiconductors in particular, offers attractive long-term growth prospects for several reasons:

We anticipate that demand for network capacity will continue to increase, driven by:

- Internet user growth;

- higher network utilization rates; and

- the popularity of VoIP and other bandwidth-intensive applications, such as wireless data transfer and video/multimedia applications.

We believe that incumbent telecommunications carriers, integrated communication service providers and cable multiple service operators worldwide will continue to upgrade and expand legacy portions of their networks to

accommodate new service offerings and to reduce operating costs.

In developing countries, we expect that service providers will continue the build-out of telecommunication networks, many of which were previously government owned.

Moreover, we expect that network infrastructure OEMs will outsource more of their semiconductor component requirements to semiconductor suppliers, allowing the OEMs to reduce their operating cost structure by shifting their focus and investment from internal application specific integrated circuit (ASIC) semiconductor design and development to more strategic systems development.

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**Strategy**

Our objective is to grow our business and to become the leading supplier of semiconductor networking solutions to leading global network infrastructure OEMs in key enterprise, network access and metro service area market segments. To achieve this objective, we are pursuing the following strategies:

***Focus on Increasing Share in High-Growth, High-Margin Applications***

We have established strong market positions for our products in the enterprise, network access and metro service areas of the telecommunications network. We believe the markets for semiconductor products that address these applications will grow at faster rates than the markets for network infrastructure equipment in general. In addition, products which address applications in the enterprise, network access and metro service areas and perform packet processing, transmission processing and/or signal processing functions typically command higher average selling prices and higher margins, primarily due to their functional complexity and their software content. These two key attributes are expected to make the enterprise, network access and metro service areas the most attractive market segments for the foreseeable future. We believe that our three core technology competencies, coupled with focused investments in product development, will position us to increase our share in those target areas.

***Expand Strategic Relationships with Industry-Leading Global Network Infrastructure OEMs and Maximize Design Win Share***

We identify and selectively establish strategic relationships with market leaders in the network infrastructure equipment industry to develop next-generation products and, in some cases, customized solutions for their specific needs. We have an extensive history of working closely with our customers' research and development and marketing teams to understand emerging markets, technologies and standards, and we invest our product development resources in those areas. We believe our close relationships with leading network infrastructure OEMs facilitate early adoption of our semiconductor products during development of their system-level products, enhance our ability to obtain design wins from those customers and encourage adoption of our technology throughout the industry.

In North America, we have cultivated close relationships with leading network infrastructure OEMs, including Cisco Systems, Inc., McData Corporation and Nortel Networks, Inc. Abroad, we have established close relationships with market leaders such as Huawei Technologies Co., Ltd., Mitsubishi Electric Corporation, TrueLight Corporation and Zhongxing Telecom Equipment Corp. in the Asia-Pacific region and Alcatel Data Networks, S.A., Siemens A.G. and LM Ericsson Telephone Company in Europe.

***Capitalize on the Breadth of Our Product Portfolio***

We build on the breadth of our product portfolio of physical-layer devices, together with our signal and packet processing devices and communications software expertise, to increase our share of the silicon content in our customers' products. We offer a range of complementary products that are optimized to work with each other and provide our customers with complete information receipt, processing and transmission functions. These complementary products allow infrastructure OEMs to source components that provide proven interoperability from a single semiconductor supplier, rather than requiring OEMs to combine and coordinate individual components from multiple vendors. In addition, we offer highly integrated products such as our family of Comcerto® VoIP processor solutions that provide our customers with a complete hardware and software solution in a single device. These integrated products perform functions typically requiring multiple discrete components and software. We believe that this strategy of offering both complementary and integrated products increases product performance, speeds time-to-market and lowers the total system cost for our customers.



The breadth of our product portfolio also provides a competitive advantage for serving network convergence applications such as multiprotocol wireless-to-wireline connectivity. These applications generally require a combination of processing, transmission or switching functionality to move high-speed voice and data traffic using multiple communications protocols across disparate communications networks.

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### ***Provide Outstanding Technical Support and Customer Service***

We provide broad-based technical and product design support to our customers through three dedicated teams: field application engineers; product application engineers; and technical marketing personnel. We believe that comprehensive service and support are critical to shortening our customers' design cycles and maintaining a long-term competitive position within the network infrastructure equipment market. Outstanding customer service and support are important competitive factors for semiconductor component suppliers like us seeking to be the preferred suppliers to leading network infrastructure OEMs.

### **Products**

We provide network infrastructure OEMs with a broad portfolio of advanced semiconductor networking solutions, ranging from physical-layer transceivers and framers to higher-layer network processors. Our products can be classified into three focused product families: high-performance analog products; multiservice access digital signal processor (DSP) products; and wide-area networking (WAN) communications products. These three product families are found in a variety of networking equipment designed to process, transmit and switch voice, data and video traffic between, and within, the different segments of the communications network.

#### ***High-Performance Analog Products***

Our high-performance analog transmission devices and switching products support storage area networking, fiber-to-the-premise and broadcast video, as well as mainstream synchronous optical networking (SONET)/synchronous digital hierarchy (SDH) and packet-over-SONET applications, typically operating at data transmission rates between 155 megabits per second (Mbps) and 10 gigabits per second (Gbps). Our transmission products include laser drivers, transimpedance amplifiers, post amplifiers, clock and data recovery circuits, serializers/deserializers, video reclockers, cable drivers and line equalizers. These products serve as the connection between a fiber optic or coaxial cable component interface and the remainder of the electrical subsystem in various network equipment and perform a variety of functions, including:

- converting incoming optical signals from fiber optic cables to electrical signals for processing and transport over a wireline medium and vice-versa;

- conditioning the signal to remove unwanted noise or errors;

- combining lower speed signals from multiple parallel paths into higher speed serial paths, and vice-versa, for bandwidth economy; and

- amplifying and equalizing weaker signals as they pass through a particular system's equipment, media or network.

Our switching products include a family of high-speed crosspoint switches capable of switching traffic up to 4.25 Gbps within various types of network switching equipment. These crosspoint switches direct, or transfer, a large number of high-speed data input streams, regardless of traffic type, to different connection trunks for rerouting the information to new destination points in the network. Crosspoint switches are often used to provide redundant traffic paths in networking equipment to protect against the loss of critical data from spurious network outages or failures that may occur from time-to-time. Target equipment applications for our switching products include add-drop multiplexers, high-density IP switches, storage-area routers and optical cross-connect systems. In addition, we offer crosspoint switches optimized for standard and high-definition broadcast video routing and production switching applications at rates up to 3 Gbps.

***Multiservice Access DSP Products***

Our software-configurable multiservice access DSP products serve as bridges for transporting voice, data and video between circuit-switched networks and packet-based networks. Our multiservice access DSP device architecture combines the performance of a digital-signal processor core with the flexibility of a microcontroller core to support our extensive suite of modulation techniques, echo cancellers, speech coders and communications protocols. These products process and translate voice, data and video signals and perform various management and

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reporting functions that help determine the appropriate amount of bandwidth required for transporting the signals to the next destination. They compress the signals to minimize bandwidth consumption and modify or add communications protocols to accommodate transport of the signals across a variety of different services and networks. Supported services include VoIP, voice-over-ATM (VoATM) and voice-over-DSL services, as well as wireline-to-wireless connectivity.

Our Comcerto® family of voice-over-packet (VoP) communications processors includes a full range of pin- and software-compatible enterprise and carrier-class voice processing solutions that enable OEMs to provide scalable systems with customized features. The high-density members of this family, the Comcerto 600 and Comcerto 700 series processors and related software, provide a complete system-on-a-chip solution for carrier-class VoIP and VoATM applications. The Comcerto 600 is capable of handling more than 256 channels of both VoIP and VoATM traffic, while the Comcerto 700 supports more than 400 channels. Both are targeted for use in digital loop carriers and voice and media gateways designed to bridge wireless, wireline and enterprise networks.

The Comcerto 500 and 800 series solutions are designed for enterprise voice and data processing applications. The Comcerto 500 series is a silicon PBX-on-a-chip which supports all required voice processing functionality for up to 64 channels, including encryption. The Comcerto 800 series enables a new class of office-in-a-box systems by combining a high-quality VoP subsystem with a high-performance routing and virtual private network (VPN) engine. The Comcerto 800 series integrates voice processing, packet processing and encryption functionality into a single device for the rapidly growing market for VoP enterprise networks. This product is targeted for use in enterprise voice gateways, IP PBXs and integrated access devices (IADs).

### ***Wide-Area Networking Communications Products***

Our WAN communications products include transmission solutions and high-performance ATM/multi-protocol label switching (MPLS) network processors that facilitate the aggregation, processing and transport of voice and data traffic over copper wire or fiber optic cable to access metropolitan and long-haul networks.

Our T1/E1, T3/E3 and SONET carrier devices incorporate high-speed analog, digital and mixed-signal circuit technologies and include multi-port framers and line interface units (LIUs) or transceivers for 1.5 Mbps to 155 Mbps data transmission. Framers format data for transmission and extract data at reception, while LIUs condition signals for transmission and reception over multiple media. Our link-layer products include multi-channel, high-level data link channel (HDLC) communications controllers and multi-channel, inverse multiplexing over ATM (IMA) traffic controllers. The IMA protocol enables the aggregation of multiple T1 or DSL lines to deliver higher data rates using existing ATM infrastructure while the HDLC protocol is used for the packetization of data and the transfer of messaging and signaling information across the network. We also offer a family of symmetric DSL (SDSL) transceivers which enable service providers to deliver Internet access at data transmission rates of 1.5 Mbps to 5.7 Mbps in both directions over copper wire, supporting telecommuting and branch office functions worldwide.

Our high-performance ATM/MPLS network processors are designed to offer advanced protocol translation and traffic management capabilities. Protocol translation occurs where different types of networks and protocols interconnect. Traffic management describes a collection of functions which are used to optimally allocate network bandwidth and allow service providers to provide differentiated services over their networks. Our software-programmable devices operate at data transmission rates from 1.5 Mbps to 2.5 Gbps. Our network processor devices address internetworking applications, including ATM segmentation and reassembly, and a variety of traffic management functions, including traffic shaping, traffic policing and queue management, required by these applications.

Our wide-area networking communications products are designed for use in a variety of equipment including digital loop carriers, DSL access multiplexers, add-drop multiplexers, switches, high-speed routers, digital cross-connect

systems, optical edge devices, multiservice provisioning platforms, voice gateways and wireless base station controllers.

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### **Customers**

We market and sell our semiconductor networking solutions directly to leading network infrastructure OEMs. We also sell our products indirectly through electronic component distributors and third-party electronic manufacturing service providers, which manufacture products incorporating our semiconductor networking solutions for OEMs. Sales to distributors accounted for approximately 49% of our revenues for fiscal 2006. For fiscal 2006, distributors Avnet, Inc. and Alltek Technology Corporation and manufacturing service provider Jabil Circuit, Inc. accounted for 17%, 11%, and 11%, respectively, of our net revenues.

Our top five direct OEM customers for fiscal year 2006 were Alcatel Data Networks, S.A., Fujitsu Limited, Huawei Technologies Co., Ltd., Sonus Networks, Inc. and Zhongxing Telecom Equipment Corp. While our direct sales to these customers accounted for a total of approximately 14% of our fiscal 2006 net revenues, we believe indirect sales to these same customers represent a significant additional portion of our net revenues. Including indirect sales, we believe that Cisco Systems, Inc. accounted for approximately 18% of our fiscal 2006 net revenues and that no other OEM customer accounted for 10% or more of our net revenues. We believe that our significant indirect network infrastructure OEM customers for fiscal year 2006 also included McData Corporation, Mitsubishi Electric Corporation, Nortel Networks, Inc., Siemens A.G. and TrueLight Corporation.

Our customer base is widely dispersed geographically. Revenues derived from customers located in the Americas, Europe, and the Asia-Pacific region were 34%, 12% and 54%, respectively, of our total revenues for 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. See Item 8. Financial Statements and Supplementary Data, including Note 2 and Note 14 of Notes to Consolidated Financial Statements for additional information on customers and geographic areas.

### **Sales, Marketing and Technical Support**

We have a worldwide sales, marketing and technical support organization comprised of 105 employees as of October 27, 2006, located in 6 domestic and 8 international sales locations. Our marketing, sales and field applications engineering teams, augmented by 17 electronic component distributors and 12 sales representative organizations, focus on marketing and selling semiconductor networking solutions to worldwide network infrastructure OEMs.

We maintain close working relationships with our customers throughout their lengthy product development cycle. Our customers may need six months or longer to test and evaluate our products and an additional six months or longer to begin volume production of network infrastructure equipment that incorporates our products. During this process, we provide broad-based technical and product design support to our customers through our field application engineers, product application engineers and technical marketing personnel. We believe that providing comprehensive product service and support is critical to shortening our customers' design cycles and maintaining a competitive position in the network infrastructure equipment market.

### **Operations and Manufacturing**

We are a fabless company, which means we do not own or operate foundries for wafer fabrication or facilities for device assembly and final test of our products. Instead, we outsource wafer fabrication, assembly and testing of our semiconductor products to independent, third-party contractors. We use mainstream digital complementary metal-oxide semiconductor (CMOS) process technology for the majority of our products; we rely on specialty processes for the remainder of products. Taiwan Semiconductor Manufacturing Co., Ltd. (TSMC) is our principal foundry supplier of CMOS wafers and die. Our primary foundry supplier for specialty process requirements is Jazz Semiconductor, Inc. We use several other suppliers for wafers used in older products. We believe that the raw

materials, parts and supplies required by our foundry suppliers are generally available at present and will be available in the foreseeable future.

Semiconductor wafers are usually shipped to third-party contractors for device assembly and packaging where the wafers are cut into individual die, packaged and tested before final shipment to customers. We use Amkor Technology, Inc. and other third-party contractors, located in the Asia-Pacific region, Europe and California, to

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satisfy a variety of assembly and packaging technology and product testing requirements associated with the back-end portion of the manufacturing process.

We qualify each of our foundry and back-end process providers. This qualification process consists of a detailed technical review of process performance, design rules, process models, tools and support, as well as analysis of the subcontractor's quality system and manufacturing capability. We also participate in quality and reliability monitoring through each stage of the production cycle by reviewing electrical and parametric data from our wafer foundry and back-end providers. We closely monitor wafer foundry production for overall quality, reliability and yield levels.

**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 suppliers that are both larger and smaller than us in terms of resources and market share. We expect intense competition to continue.

Our principal competitors are Agere Systems, Inc., Applied Micro Circuits Corporation, Centillium Communications, Inc., Conexant Systems, Inc., Exar Corporation, Freescale Semiconductor, Inc., Gennum Corporation, Infineon Technologies A.G., Maxim Integrated Products, Inc., PMC-Sierra, Inc., Texas Instruments Incorporated, Transwitch Corporation and Vitesse Semiconductor Corporation.

We believe that the principal competitive factors for semiconductor suppliers in each of our served markets are:

- time-to-market;
- product quality, reliability and performance;
- customer support;
- price and total system cost;
- new product innovation; and
- compliance with industry standards.

While we believe that we compete favorably with respect to each of these factors, 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;
- 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 devote greater resources to the development, promotion and sale of their products than we can. Our competitors may also be able to adapt more quickly to new or emerging technologies and



changes in customer requirements or may be more able to respond to the cyclical fluctuations or downturns that affect the semiconductor industry from time to time. Moreover, we have incurred substantial operating losses, and we anticipate future losses. If we are not successful in assuring our customers of our financial stability, our OEM customers may choose semiconductor suppliers whom they believe have a stronger financial position or liquidity, which may materially adversely affect our business.

**Backlog**

Our sales are made primarily pursuant to standard purchase orders for delivery of products. Because industry practice allows customers to cancel orders with limited advance notice to us prior to shipment, we believe that backlog as of any particular date is not a reliable indicator of our future revenue levels.

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### **Research and Development**

We have significant research, development, engineering and product design capabilities. As of October 27, 2006, we had 282 employees engaged in research and development activities. We perform research and product development activities at our headquarters in Newport Beach, California and at 7 design centers. In order to enhance the cost-effectiveness of our operations, we have increasingly sought to shift portions of our research and development operations to jurisdictions with lower cost structures than that available in the United States. Our design centers are strategically located to take advantage of key technical and engineering talent. 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. In addition, we actively collaborate with technology leaders to define and develop next-generation technologies.

We spent approximately \$64.1 million, \$71.4 million, and \$79.6 million on research and development activities in fiscal years 2006, 2005 and 2004, respectively. The decreases in our research and development expenses reflect the workforce reductions and other cost reduction actions we implemented in fiscal years 2002 through 2006.

### **Intellectual Property**

Our success and future revenue growth depend, in part, on the intellectual property that we own and develop, including patents, licenses, trade secrets, know-how, trademarks and copyrights, and on our ability to protect our intellectual property. We continuously review our patent portfolio to maximize its value to us, abandoning inapplicable or less useful patents and filing new patents important to our product roadmap. Our patent portfolio may be used to avoid, defend or settle any potential litigation with respect to various technologies contained in our products. The portfolio may also provide negotiating leverage in attempts to cross-license patents or technologies with third parties and it may provide licensing opportunities in the future. 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. In connection with our participation in the development of various industry standards, we may be required to reasonably license certain of our patents to other parties, including competitors that develop products based upon the adopted industry standards. We have also entered into agreements with certain of our customers and granted these customers the right to use our proprietary technology in the event that we file for bankruptcy protection or take other equivalent actions. While in the aggregate our intellectual property is considered important to our operations, no single patent, license, trade secret, know-how, trademark or copyright is considered of such importance that its loss or termination would materially affect our business or financial condition.

### **Employees**

As of October 27, 2006, we had 512 full-time employees, of whom approximately 340 were engineers. Our employees are not covered by any collective bargaining agreements and we have not experienced a work stoppage in the past five years. We believe our future success will depend in large part on our ability to continue to attract, motivate, develop and retain highly skilled and dedicated technical, marketing and management personnel.

### **Cyclicality**

The semiconductor industry is highly cyclical and is characterized by constant and rapid technological change, rapid product obsolescence and price erosion, evolving technical standards, short product life cycles and wide fluctuations in product supply and demand. From time to time these and other factors, together with changes in general economic conditions, cause significant upturns and downturns in the industry, and in our business in particular.

In addition, our operating results are subject to substantial quarterly and annual fluctuations due to a number of factors, such as demand for network infrastructure equipment, the timing of receipt, reduction or cancellation of significant orders, fluctuations in the levels of component inventories held by our customers, the gain or loss of significant customers, market acceptance of our products and our customers' products, our ability to develop,

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introduce and market new products and technologies on a timely basis, the availability and cost of products from our suppliers, new product and technology introductions by competitors, intellectual property disputes, and the timing and extent of product development costs.

### **Available Information**

We maintain an Internet website at <http://www.mindspeed.com>. Our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and amendments to such reports filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act, and other information related to our company, are available free of charge on this site as soon as reasonably practicable after such reports are filed with or furnished to the Securities and Exchange Commission (SEC). Our Standards of Business Conduct, Guidelines on Corporate Governance and Board Committee Charters are also available on our website. We will provide reasonable quantities of paper copies of filings free of charge upon request. In addition, we will provide a copy of the Board Committee Charters to stockholders upon request. No portion of our Internet website or the information contained in or connected to the website is incorporated into this Annual Report on Form 10-K.

### **Item 1A. 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, and we anticipate additional future losses.***

We incurred a net loss of \$24.5 million for fiscal 2006 compared to net losses of \$62.6 million in 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 the first half of fiscal 2007, 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 reduce operating expenses or achieve substantial revenue growth. Through fiscal 2006, we have completed a series of cost reduction actions which have improved our operating cost structure. We plan to continue with cost reduction actions in the first half of fiscal 2007. These expense reductions alone may not make us profitable or allow us to sustain profitability if it is achieved. 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. 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 completed cost reduction measures taken in fiscal 2006 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 periods. 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 fiscal 2006, our net cash used in operating activities was \$15.9 million compared to net cash used in operating activities of \$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 September 30, 2006, our

cash and cash equivalents totaled \$30.0 million and our marketable securities totaled \$11.3 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

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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;
- 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.

***The increasing significance of our foreign operations exposes us to risks that are beyond our control and could affect our ability to operate successfully.***

In order to enhance the cost-effectiveness of our operations, we have increasingly sought to shift portions of our research and development and customer support operations to jurisdictions with lower cost structures than that available in the United States. The transition of even a portion of our business operations to new facilities in a foreign country involves a number of logistical and technical challenges that could result in product development delays and operational interruptions, which could reduce our revenues and adversely affect our business. We may

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encounter complications associated with the set-up, migration and operation of business systems and equipment in a new facility. This could result in delays in our research and development efforts and otherwise disrupt our operations. If such delays or disruptions occur, they could damage our reputation and otherwise adversely affect our business and results of operations.

To the extent that we shift any operations or labor offshore to jurisdictions with lower cost structures, we may experience challenges in effectively managing those operations as a result of several factors, including time zone differences and regulatory, legal, cultural and logistical issues. Additionally, the relocation of labor resources may have a negative impact on our existing employees, which could negatively impact our operations. If we are unable to effectively manage our offshore research and development staff and any other offshore operations, our business and results of operations could be adversely affected.

We cannot be certain that any shifts in our operations to offshore jurisdictions will ultimately produce the expected cost savings. We cannot predict the extent of government support, availability of qualified workers, future labor rates, or monetary and economic conditions in any offshore locations where we may operate. Although some of these factors may influence our decision to establish or increase our offshore operations, there are inherent risks beyond our control, including:

political uncertainties;

wage inflation;

exposure to foreign currency fluctuations;

tariffs and other trade barriers; and

foreign regulatory restrictions and unexpected changes in regulatory environments.

We will likely be faced with competition in these offshore markets for qualified personnel, including skilled design and technical personnel, and we expect this competition to increase as companies expand their operations offshore. If the supply of such qualified personnel becomes limited due to increased competition or otherwise, it could increase our costs and employee turnover rates. One or more of these factors or other factors relating to foreign operations could result in increased operating expenses and make it more difficult for us to manage our costs and operations, which could cause our operating results to decline and result in reduced revenues.

***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 or better financed than we are, or who have superior contractual rights to enforce manufacture of their products, including to the exclusion of producing our products.

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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 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

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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;
- 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

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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 49% of our net revenues for 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 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

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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.

***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. We generally enter into confidentiality agreements with our employees, consultants and strategic partners. We also try to control access to and distribution of our technologies, documentation and other proprietary information. Despite these efforts, internal or external parties may attempt to copy, disclose, obtain or use our products, services or technology without our authorization. Also, former employees may seek employment with our business partners, customers or competitors, and we cannot assure you that the confidential nature of our proprietary information will be maintained in the course of such future employment. Further, in some countries outside the United States, patent protection is not available or not reliably enforced. Some countries that do allow registration of patents do not provide meaningful redress for patent violations. As a result, protecting intellectual property in those countries is difficult and competitors may sell products in those countries that have functions and features that infringe on our intellectual property.



***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

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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. We intend to continue to expand our international business activities including expansion of design and operational centers abroad and may have difficulty attracting and maintaining international 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 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.***

A significant part of our strategy involves our continued pursuit of growth opportunities in a number of international markets. We market, sell, design and service our products internationally. For fiscal 2006, approximately 70% 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, customer support 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;

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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;

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

cultural differences in the conduct of business; and

natural disasters, acts of terrorism and war.

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. As we continue to shift a portion of our operations offshore, more of our expenses are incurred in currencies other than those in which we bill for the related services. An increase in the value of certain currencies, such as the Ukrainian hryvnia and Indian rupee, against the U.S. dollar could increase costs of our offshore operations by increasing labor and other costs that are denominated in local 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

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.

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***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 or sustain profitability, if achieved, within the forecasted time period;
- 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 Global 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.

***Our results of operations could vary as a result of the methods, estimates and judgments we use in applying our accounting policies.***

The methods, estimates and judgments we use in applying our accounting policies have a significant impact on our results of operations. Such methods, estimates and judgments are, by their nature, subject to substantial risks, uncertainties and assumptions, and factors may arise over time that lead us to change our methods, estimates and judgments. Changes in those methods, estimates and judgments could significantly affect our results of operations. In particular, beginning in our first quarter of fiscal 2006, the calculation of share-based compensation expense under SFAS No. 123R required us to use valuation methodologies (which were not developed for use in valuing employee stock options) and a number of assumptions, estimates and conclusions regarding matters such as expected forfeitures, expected volatility of our share price, the expected dividend rate with respect to our common stock and the exercise behavior of our employees. There are no means, under applicable accounting principles, to compare and adjust our expense if and when we learn of additional information that may affect the estimates that we previously made, with the exception of changes in expected forfeitures of share-based awards. Factors may arise over time that lead us to change our estimates and assumptions with respect to future share-based compensation arrangements, resulting in variability in our share-based compensation expense over time. Changes in forecasted share-based compensation expense could impact our gross margin percentage; research and development expenses; and selling, general and administrative expenses.

***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

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decline or market demand for our common stock could be sharply reduced. As of September 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 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

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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

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.

**Item 1B. *Unresolved Staff Comments***

None.

**Item 2. *Properties***

At October 27, 2006, we occupied our headquarters located in Newport Beach, California (which includes design and sales offices), 7 design centers and 13 sales locations. These facilities had an aggregate floor space of approximately 268,000 square feet, all of which is leased, consisting of approximately 193,000 square feet at our headquarters, 58,000 square feet at our design centers and 17,000 square feet at our sales locations. We believe our properties are well maintained, are in sound operating condition and contain all the equipment and facilities to operate at present levels.

Through our design centers, we provide design engineering and product application support and after-sales service to our OEM customers. The design centers are strategically located to take advantage of key technical and engineering talent worldwide.

**Item 3. *Legal Proceedings***

We are currently not engaged in legal proceedings that require disclosure under this Item.

**Item 4. *Submission of Matters to a Vote of Security Holders***

No matters were submitted to a vote of our stockholders during the quarter ended September 30, 2006.

**Table of Contents****PART II****Item 5. *Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities*****Market Information**

Our common stock is traded on the Nasdaq Global Market under the symbol MSPD. From June 30, 2003 to December 12, 2003, our common stock was traded on the American Stock Exchange. Prior to June 30, 2003, we were a wholly owned subsidiary of Conexant. The following table lists the high and low sales price of our common stock as reported by the Nasdaq Global Market or the American Stock Exchange, as applicable, for the periods indicated.

	<b>High</b>	<b>Low</b>
<b><i>Fiscal 2005</i></b>		
Quarter ended December 31, 2004	\$ 2.98	\$ 1.81
Quarter ended March 31, 2005	\$ 2.88	\$ 2.04
Quarter ended June 30, 2005	\$ 2.22	\$ 1.14
Quarter ended September 30, 2005	\$ 2.45	\$ 1.15
<b><i>Fiscal 2006</i></b>		
Quarter ended December 31, 2005	\$ 2.38	\$ 1.70
Quarter ended March 31, 2006	\$ 4.05	\$ 2.41
Quarter ended June 30, 2006	\$ 4.25	\$ 2.30
Quarter ended September 30, 2006	\$ 2.62	\$ 1.39

**Recent Share Prices and Holders**

The last reported sale price of our common stock on November 27, 2006 was \$1.70 and there were approximately 39,032 holders of record of our common stock. However, many holders' shares are listed under their brokerage firms names. We estimate our actual number of beneficial stockholders to be approximately 170,000.

**Dividend Policy**

We have never paid cash dividends on our capital stock. We currently intend to retain any earnings for use in our business and do not anticipate paying cash dividends in the foreseeable future.

**Issuer Purchases of Equity Securities**

<b>Total Number of</b>	<b>Average Price</b>	<b>Total Number of Shares (or Units) Purchased as Part</b>	<b>Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May yet be</b>
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	<b>Shares (or Units)  Purchased</b>	<b>Paid per Share  (or Unit)</b>	<b>of Publicly Announced Plans or Programs</b>	<b>Purchased Under the Plans or Programs</b>
July 1, 2006 to July 28, 2006	43,003(a)	\$ 1.85		
July 29, 2006 to August 25, 2006	1,788(a)	\$ 1.79		
August 26, 2006 to September 29, 2006	(a)	\$		
	44,791	\$ 1.85		

(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.

**Table of Contents****Item 6. Selected Financial Data**

The selected consolidated financial data presented below should be read in conjunction with Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations and our consolidated financial statements and the notes thereto appearing elsewhere in this Annual Report on Form 10-K. Our consolidated selected financial data have been derived from our audited consolidated financial statements. The selected financial data include our results of operations and financial position while we were part of Conexant prior to June 27, 2003. The financial data for periods prior to June 27, 2003 do not reflect what our results of operations and financial position would have been if we had operated as an independent public company during those periods.

	<b>Year Ended September 30,</b>				
	<b>2006</b>	<b>2005</b>	<b>2004</b>	<b>2003</b>	<b>2002</b>
	<b>(In thousands, except per share amounts)</b>				
<b>Statement of Operations Data</b>					
Net revenues	\$ 135,919	\$ 111,777	\$ 119,435	\$ 81,906	\$ 80,036
Cost of goods sold	43,592	33,704	35,149	25,127	29,410
Gross margin	92,327	78,073	84,286	56,779	50,626
Operating expenses:					
Research and development	64,104	71,355	79,582	106,289	167,148
Selling, general and administrative	46,970	41,871	46,845	49,656	69,500
Amortization of intangible assets		20,481	50,318	51,223	312,388
Special charges(1)	2,550	5,999	387	27,170	168,866
Total operating expenses	113,624	139,706	177,132	234,338	717,902
Operating loss	(21,297)	(61,633)	(92,846)	(177,559)	(667,276)
Interest expense	(2,231)	(1,788)			
Other income (expense), net	863	1,162	320	1,078	(298)
Loss before income taxes	(22,665)	(62,259)	(92,526)	(176,481)	(667,574)
Provision for income taxes	1,849	370	721	780	699
Loss before cumulative effect of accounting change	(24,514)	(62,629)	(93,247)	(177,261)	(668,273)
Cumulative effect of change in accounting for goodwill(2)				(573,184)	
Net loss	\$ (24,514)	\$ (62,629)	\$ (93,247)	\$ (750,445)	\$ (668,273)
Loss per share, basic and diluted:					
Loss before cumulative effect of accounting change	\$ (0.23)	\$ (0.61)	\$ (0.95)	\$ (1.98)	\$ (7.74)
Cumulative effect of change in accounting for goodwill(2)				(6.39)	

Net loss	\$	(0.23)	\$	(0.61)	\$	(0.95)	\$	(8.37)	\$	(7.74)
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	As of September 30,				
	2006	2005	2004	2003	2002
<b>Balance Sheet Data</b>					
Working capital	\$ 50,880	\$ 59,332	\$ 49,082	\$ 71,783	\$ (35,430)
Total assets	96,542	105,504	126,300	203,889	787,111
Long-term debt	44,618	44,219			
Stockholders' equity	23,476	33,826	90,927	167,134	720,323

(1) Special charges consist of asset impairments, restructuring charges, separation costs and gains and losses on the sale of certain assets.

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- (2) Effective October 1, 2002, we adopted Statement of Financial Accounting Standards No. 142, Goodwill and Other Intangible Assets, and recorded an impairment charge of \$573.2 million to write down the carrying value of goodwill to estimated fair value.

**Item 7. *Management's Discussion and Analysis of Financial Condition and Results of Operations***

**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, Mitsubishi Electric Corporation, Siemens A.G. and Zhongxing Telecom Equipment Corp.

**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 49% of our revenues for fiscal 2006. Sales to customers located outside the United States, primarily in the Asia-Pacific region and Europe, were approximately 70% of our net revenues for 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 \$64.1 million on research and development for fiscal 2006. 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 upturn 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 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

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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 reduce operating expenses or achieve substantial revenue growth. Through fiscal 2006, we have completed a series of cost reduction actions which have improved our operating cost structure.

We plan to continue with cost reduction actions in the first half of fiscal 2007. 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 the first quarter of fiscal 2007, we announced a restructuring plan. We anticipate incurring special charges of \$4.2 million during the first and second quarters of fiscal 2007, primarily associated with severance costs for affected employees and the impairment of certain excess space at the Newport Beach headquarters. When we complete these restructuring actions, we expect to achieve annualized savings of approximately \$14 million.

## **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 revised our stock-based compensation arrangements to provide current and long-term incentive compensation, principally through restricted stock awards. During fiscal 2006, we granted an aggregate of 4.2 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. Certain senior management personnel also received additional restricted stock awards having vesting tied to our achievement of an operating profit.

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* using the modified prospective application. 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

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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 \$7.5 million and \$400,000 for 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 fiscal 2006, as well as the cost of awards outstanding at October 1, 2005 but vesting after that date. As of September 30, 2006, there was unrecognized compensation expense of \$2.1 million related to unvested stock options, which we expect to recognize over a weighted-average period of 2.3 years and unrecognized compensation expense of \$3.8 million related to unvested restricted stock awards, which we expect to recognize over a weighted-average period of 2.6 years.

### **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 now trades on the Nasdaq Global 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.

### **Critical Accounting Policies**

The preparation of financial statements in accordance with accounting principles generally accepted in the United States requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Among the significant estimates affecting our consolidated financial statements are those relating to inventories, revenue recognition, allowances for doubtful accounts, stock-based compensation, income taxes and impairment of long-lived assets. 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

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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 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.

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

## **Recent Accounting Pronouncements**

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

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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 de-recognition, 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 our first fiscal quarter of fiscal 2008. The Company is in the process of evaluating the effect, if any, the adoption of FIN 48 will have on its financial statements.

In September 2006, the SEC released Staff Accounting Bulletin (SAB) No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*, which addresses how uncorrected errors in previous years should be considered when quantifying errors in current-year financial statements. SAB 108 requires registrants to consider the effect of all carry over and reversing effects of prior-year misstatements when quantifying errors in current-year financial statements. SAB 108 allows registrants to record the effects of adopting the guidance as a cumulative-effect adjustment to retained earnings. We will adopt SAB 108 as of the beginning of fiscal 2007 and do not expect that the adoption of SAB 108 will have a material impact on our financial condition or results of operations.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurement* ( SFAS 157 ), which defines fair value, establishes a framework for measuring fair value and expands disclosures about assets and liabilities measured at fair value. We will be required to adopt SFAS 157 in the first quarter of fiscal 2009. Management is currently evaluating the requirements of SFAS 157 and has not yet determined the impact on the consolidated financial statements.

**Results of Operations**

***Fourth Quarter Fiscal 2006 Compared to Fourth Quarter Fiscal 2005***

In fiscal 2005, our fourth quarter net revenues grew 17% year over year, reaching \$31.1 million. Our quarterly operating loss for the fiscal 2005 fourth quarter decreased to \$4.6 million. The improvement in our operating loss reflects the revenue growth we achieved, a \$4.8 million decrease in combined quarterly research and development and selling, general and administrative expenses and a \$12.6 million decrease in amortization of intangible assets.

In the fourth quarter of fiscal 2006, our net revenues grew 4% year over year, reaching \$32.2 million. Our fiscal 2006 fourth quarter net revenues decreased approximately 10% from fiscal 2006 third quarter net revenues of \$35.9 million. Our operating loss for the fiscal 2006 fourth quarter was \$7.0 million compared to \$4.6 million in the fourth quarter of fiscal 2005. The increase in our operating loss reflects a lower gross margin of \$1.4 million and increased operating expenses mainly due to an increase in stock based compensation expense of \$1.5 million.

**Net Revenues**

***Fiscal 2006 Compared to Fiscal 2005; Fiscal 2005 Compared to Fiscal 2004***

The following table summarizes our net revenues:

<b>2006</b>	<b>Change</b>	<b>2005</b>	<b>Change</b>	<b>2004</b>
-------------	---------------	-------------	---------------	-------------



(Dollars in millions)

Multiservice access DSP products	\$ 37.4	13%	\$ 33.1	25%	\$ 26.5
High-performance analog products	42.7	58%	27.1	10%	24.6
WAN communications products	55.8	8%	51.6	(24)%	68.0
Other					0.3
Net revenues	\$ 135.9	22%	\$ 111.8	(6)%	\$ 119.4

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For fiscal 2006, the 22% increase in our net revenues compared to fiscal 2005 reflects higher sales volumes across each of our product families. Net revenues from our multiservice access DSP products increased \$4.3 million, or 13%, 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. Net revenues from our high-performance analog products increased by \$15.6 million, or 58%, benefiting from increased shipments of our crosspoint switches, physical media dependent devices serving fiber optic markets and video infrastructure products serving standard and high definition broadcast video markets. Sales of our WAN communications products increased by \$4.2 million, or 8%, reflecting increased shipments of our T/E carrier transmission products serving metro access and aggregation as well as wireless markets, partially offset by lower demand for our ATM/MPLS network processor products serving router markets.

The 6% decrease in our net revenues for fiscal 2005 compared to fiscal 2004 reflects lower sales volumes in our WAN communications products, partially offset by increased shipments of our multiservice access DSP products and our high performance analog products. Sales of our multiservice access DSP products benefited from increased shipments of our Comcerto series VoIP processors for use in VoIP applications. In our high performance analog products, we saw increased demand for our crosspoint switches, including video applications, and our physical media dependent devices. Net revenues from our WAN communications products reflect lower demand for our T1/E1 and T3/E3 line interface units and DSL transceivers resulting from a slowdown in consumption of our products in access and metropolitan area network applications. Sales of WAN communications products also reflect the lower demand we experienced for our ATM/MPLS network processor products for use in wireless, enterprise and broadband infrastructure applications.

**Gross Margin**

	<b>2006</b>	<b>Change</b>	<b>2005</b>	<b>Change</b>	<b>2004</b>
	<b>(Dollars in millions)</b>				
Gross margin	\$ 92.3	18%	\$ 78.1	(7)%	\$ 84.3
Percent of net revenues	68%		70%		71%

Gross margin represents net revenues less cost of goods sold. As a fabless semiconductor company, we use third parties (including TSMC, Jazz and Amkor) 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 fiscal 2006 increased \$14.2 million over fiscal 2005, principally reflecting the 22% increase in our net revenues and the favorable effect of increased manufacturing volumes, net favorable impact of higher than anticipated manufacturing yields, a net decrease in the provision for excess and obsolete inventories partially offset by a greater level of depreciation on photomask production tooling and a higher level of variable manufacturing overhead. Our gross margin as a percent of net revenues for fiscal 2006 declined from fiscal 2005 primarily as a result of a reduction in the benefit related to the sale of inventory previously written down to a zero cost basis in 2001. The change in provision for excess and obsolete inventories was a credit of \$586,000 for fiscal 2006, compared to an increase in the provision of \$489,000 for fiscal 2005. Our gross margin for fiscal 2005 compared to fiscal 2004 reflects the 6% decrease in our annual net revenues and the adverse impact of lower manufacturing volumes we experienced in fiscal 2005. These factors were partially offset by a lower provision for excess and obsolete goods.

Our gross margins also benefited from the sale of inventories with an original cost of \$5.5 million (2006), \$8.7 million (2005), and \$9.0 million (2004) 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 time of the write-downs. The previously written-down inventories were generally sold at prices which exceeded their original cost.

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,

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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 September 30, 2006, we scrapped a portion of these inventories having an original cost of \$39.1 million and sold a portion of these inventories with an original cost of \$32.0 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 September 30, 2006, we continued to hold inventories with an original cost of \$12.4 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 continue to experience a 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.

**Research and Development**

	<b>2006</b>	<b>Change</b>	<b>2005</b>	<b>Change</b>	<b>2004</b>
	<b>(Dollars in millions)</b>				
Research and development	\$ 64.1	(10)%	\$ 71.4	(10)%	\$ 79.6
Percent of net revenues	47%		64%		67%

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 fiscal 2006 compared to fiscal 2005 includes a \$4.3 million decrease in compensation and personnel-related costs partly

attributable to a one-time vacation requirement, a \$2.7 million decrease in depreciation expense and a \$2.2 million decrease in materials, supplies and mask sets, 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 personnel-related cost savings were partly offset by increased headcount and spending directed toward VoIP products and our high-performance analog products, and by a \$2.5 million increase in stock based compensation expense. The decrease in R&D expenses also reflects lower costs for materials, photomasks and preproduction devices resulting from the aforementioned expense reduction actions

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and the reduction in new product development activities in the ATM/MPLS and T/E carrier transmission product lines.

The decrease in R&D expenses for fiscal 2005 compared to fiscal 2004 primarily reflects lower headcount and personnel-related costs resulting from our expense reduction actions, including the closure of design centers in Herzlia, Israel and Lisle, Illinois, as well as lower supplies costs.

**Selling, General and Administrative**

	<b>2006</b>	<b>Change</b>	<b>2005</b>	<b>Change</b>	<b>2004</b>
	<b>(Dollars in millions)</b>				
Selling, general and administrative	\$ 47.0	12%	\$ 41.9	(11)%	\$ 46.8
Percent of net revenues	35%		37%		39%

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 fiscal 2006 compared to fiscal 2005 principally reflects a \$3.9 million increase in stock-based compensation expense, partially offset by the benefit of a one-time vacation requirement. The increase also reflects increased compensation and personnel-related costs and higher sales commissions associated with the 22% increase in sales for fiscal 2006 compared to fiscal 2005.

The decrease in our SG&A expenses for fiscal 2005 compared to fiscal 2004 primarily reflects the positive impact of lower headcount and personnel-related costs resulting from our expense reduction and restructuring actions as well as lower selling costs resulting from lower sales volumes in fiscal 2005.

**Amortization of Intangible Assets and Change in Accounting for Goodwill**

	<b>2006</b>	<b>Change</b>	<b>2005</b>	<b>Change</b>	<b>2004</b>
	<b>(Dollars in millions)</b>				
Amortization of intangible assets	\$	(100)%	\$ 20.5	(59)%	\$ 50.3

Amortization of intangible assets decreased to zero for 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.

**Special Charges**

Special charges consist of the following:

<b>2006</b>	<b>2005</b>	<b>2004</b>
<b>(In millions)</b>		

Asset impairments	\$	\$ 0.8	\$
Restructuring charges	2.6	5.2	0.4
	\$ 2.6	\$ 6.0	\$ 0.4

***Asset Impairments***

During fiscal 2005, we recorded asset impairment charges totaling \$810,000 related to property and equipment that we determined to abandon or scrap, including assets associated with the closure of our former design centers in Herzlia, Israel and Lisle, Illinois.

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.

**Table of Contents*****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 9 persons in research and development, 6 in sales and marketing and 6 in general and administrative functions. In July 2006, we continued this restructuring plan and reduced our workforce by an additional 19 employees. The affected employees included approximately 17 persons in research and development and 2 in sales and marketing. In connection with the 2006 restructuring plan, we recorded \$2.4 million of restructuring charges for fiscal 2006. These restructuring charges included \$2.1 million of severance benefits payable to 40 employees and \$294,000 for the value of stock-based compensation awards that vest without future service to us.

We expect that the workforce reductions relating to our 2006 restructuring plan will reduce our quarterly operating expenses by approximately \$1.7 million, including approximately \$1.4 million 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 2007 first 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 September 30, 2006 are as follows (in thousands):

	<b>Workforce Reductions</b>
Charged to costs and expenses	\$ 2,406
Cash payments	(1,215)
Non-cash charges	(294)
Restructuring balance at September 30, 2006	\$ 897

*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.



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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 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 fiscal 2006, we recorded additional charges of \$277,000 for severance and related benefits payable to the affected employees. Activity and liability balances related to the Mindspeed 2004 restructuring plan through September 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 at September 30, 2005	837	971	1,808
Charged to costs and expenses	277		277
Cash payments	(1,058)	(752)	(1,810)
Restructuring balance at September 30, 2006	\$ 56	\$ 219	\$ 275

*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 year ended September 30, 2006, we made cash payments of \$1.5 million under these restructuring plans and reversed \$134,000 of previously accrued costs and expenses related to contractual obligations. As of September 30, 2006, our remaining liabilities under these restructuring plans totaled \$500,000, representing amounts payable under non-cancelable leases, severance benefits to affected employees and other contractual commitments.

As of September 30, 2006, we have a remaining accrued restructuring balance for all restructuring plans totaling \$1.7 million (classified as a current liability), principally 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 2007. The payments will be funded from available cash balances and funds from product sales and are not expected to impact significantly our liquidity.

**Interest Expense**

	<b>2006</b>	<b>2005</b>	<b>2004</b>
	<b>(In millions)</b>		
Interest expense	\$ (2.2)	\$ (1.8)	\$

Interest expense for fiscal 2006 and 2005 represents interest on the \$46 million convertible senior notes we issued in December 2004. Interest expense increased for fiscal 2006, as compared to fiscal 2005, because the notes were outstanding during the entire fiscal 2006 year.

**Other Income, Net**

	<b>2006</b>	<b>2005</b>	<b>2004</b>
	<b>(In millions)</b>		
Other income, net	\$ 0.9	\$ 1.2	\$ 0.3

Other income principally consists of interest income, foreign exchange gains and losses, franchise taxes and other non-operating gains and losses. The decrease in other income in fiscal 2006 as compared to fiscal 2005 principally reflects lower interest income resulting from the lower cash, cash equivalent and marketable security balances partially offset by higher interest rates that prevailed during fiscal 2006. The increase in other income for fiscal 2005 compared to fiscal 2004 principally reflects higher interest income, partially offset by the write-off of capitalized costs associated with the terminated credit facility. The increase in interest income resulted from higher invested cash balances and the higher interest rates that prevailed during fiscal 2005.

**Table of Contents****Provision for Income Taxes**

	<b>2006</b>	<b>2005</b>	<b>2004</b>
	<b>(In millions)</b>		
Provision for income taxes	\$ 1.8	\$ 0.4	\$ 0.7

Our provision for income taxes for fiscal years 2006, 2005, and 2004 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 fiscal 2006, 2005, and 2004 will not be realized. Accordingly, we have not recognized any income tax 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 2007 will principally consist of income taxes related to our foreign operations.

As of September 30, 2006, we had a valuation allowance of \$268 million against our U.S. federal and state deferred tax assets (which reduces their carrying value to zero) because we do not expect to realize these deferred tax assets through the reduction of future income tax payments. As of September 30, 2006, we had U.S. federal net operating loss carryforwards of approximately \$603 million, including the net operating loss carryforwards we retained in the distribution.

**Table of Contents****Quarterly Results of Operations**

The following table presents our operating results for each of the eight fiscal quarters in the period ended September 30, 2006. The information for each of these quarters is derived from our unaudited interim financial statements which have been prepared on the same basis as the audited consolidated financial statements included in this Annual Report on Form 10-K. In our opinion, all necessary adjustments, which consist only of normal and recurring accruals as well as the inventory write-downs and special charges, have been included to fairly present our unaudited quarterly results. This data should be read together with our consolidated financial statements and the notes thereto included in this report.

	<b>Dec. 31, 2004</b>	<b>Mar. 31, 2005</b>	<b>June 30, 2005</b>	<b>Three Months Ended</b>				<b>Sept. 30, 2006</b>
				<b>Sept. 30, 2005</b>	<b>Dec. 31, 2005</b>	<b>Mar. 31, 2006</b>	<b>June 30, 2006</b>	
<b>Statements of Operations Data</b>								
Net revenues	\$ 26,316	\$ 26,644	\$ 27,738	\$ 31,079	\$ 33,203	\$ 34,610	\$ 35,894	\$ 32,212
Cost of goods sold	7,982	8,316	8,207	9,199	10,482	10,221	11,195	11,694
Gross margin	18,334	18,328	19,531	21,880	22,721	24,389	24,699	20,518
Research and development	19,604	18,613	16,748	16,390	16,512	17,035	15,049	15,508
Selling, general and administrative	10,662	10,430	10,797	9,982	11,036	12,462	11,807	11,665
Amortization of intangible assets	12,676	6,981	824					
Special charges	5,473	508	(125)	143	25	1,156	1,053	316
Total operating expenses	48,415	36,532	28,244	26,515	27,573	30,653	27,909	27,489
Operating loss	(30,081)	(18,204)	(8,713)	(4,635)	(4,852)	(6,264)	(3,210)	(6,971)
Interest expense	(140)	(545)	(553)	(550)	(552)	(552)	(569)	(558)
Other income (expense), net	140	291	360	371	374	354	178	(43)
Loss before income taxes	(30,081)	(18,458)	(8,906)	(4,814)	(5,030)	(6,462)	(3,601)	(7,572)
Provision (benefit) for income taxes	398	(63)	561	(526)	474	652	943	(220)
Net loss	\$ (30,479)	\$ (18,395)	\$ (9,467)	\$ (4,288)	\$ (5,504)	\$ (7,114)	\$ (4,544)	\$ (7,352)
	\$ (0.30)	\$ (0.18)	\$ (0.09)	\$ (0.04)	\$ (0.05)	\$ (0.07)	\$ (0.04)	\$ (0.07)

Net loss per  
share, basic and  
diluted

Shares used in  
computing basic  
and diluted loss  
per share

100,804	102,075	102,698	103,183	103,698	105,000	106,510	106,938
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The growth in our quarterly net revenues for fiscal 2006 generally reflects increased shipments in all of our product families; multiservice access DSP products, high performance analog products and WAN communications products.

Effective October 1, 2005, we adopted SFAS 123R Share-Based Payment and began accounting for all stock-based compensation transactions using a fair-value method and recognizing the fair value of each award as an expense over the service period. Therefore, stock-based compensation expense is included in cost of goods sold, research and development expenses, general and administrative expenses and special charges for each of the four quarters of fiscal 2006. Quarterly stock-based compensation expense for fiscal 2006 ranged from \$1.4 million to \$2.5 million and totaled \$7.5 million for fiscal 2006. Quarterly stock-based compensation expense for fiscal 2005 averaged \$100,000 per quarter and totaled \$400,000 for fiscal 2005.

Our quarterly R&D expenses generally decreased through fiscal 2005 and 2006 as a result of the workforce reductions and other cost reduction initiatives we implemented partially offset by stock-based compensation expense. Our R&D expenses of \$15.5 million for the fiscal 2006 fourth quarter reflect the effect of the cost savings from the restructuring plans we initiated in fiscal 2004 through 2006.

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Quarterly amortization of intangible assets ceased in fiscal 2006 as the remainder of our intangible assets became fully amortized during fiscal 2005.

In fiscal 2005 and fiscal 2006, we recorded special charges for our restructuring plans. Special charges for fiscal 2005 also include asset impairments totaling \$0.8 million.

Interest expense for fiscal 2005 and fiscal 2006 represents interest on the \$46 million convertible senior notes we issued in December 2004. Other income decreased during fiscal 2006 as a result of lower invested cash balances partially offset by increasing interest rates.

In the past, our quarterly operating results have fluctuated due to a number of factors, many of which are outside our control. These include changes in the overall demand for network infrastructure equipment, the timing of new product introductions, the timing of receipt, reduction or cancellation of significant orders by customers, supply availability and other factors that have had a significant impact on our revenues and gross margins. Significant quarterly fluctuations in results of operations have also caused significant fluctuations in our liquidity and working capital, including our cash and cash equivalents, accounts receivable and payable and inventories.

## **Liquidity and Capital Resources**

Cash used in operating activities was \$15.9 million for fiscal 2006 compared to \$30.2 million for fiscal 2005 and \$43.2 million for fiscal 2004. Operating cash flows for fiscal 2006 reflect our net loss of \$24.5 million, partially offset by non-cash charges (depreciation, stock compensation and other) of \$13.8 million, and net working capital increases of approximately \$5.2 million.

The net working capital increases for fiscal 2006 included a \$7.7 million increase in net inventories, principally related to our high performance analog and multiservice access VoIP products as we built inventories to support expected increases in demand. These amounts were partially offset by a \$1.6 million decrease in accounts receivable resulting from a decrease in our average collection period and a \$1.6 million increase in deferred revenue.

Cash provided by investing activities of \$25.2 million for fiscal 2006 principally consisted of net sales of marketable securities (net of purchases) of \$29.7 million, partially offset by capital expenditures of \$4.5 million. Cash used in investing activities of \$44.7 million for fiscal 2005 principally consisted of net purchases of marketable securities of \$40.9 million and capital expenditures of \$4.0 million, partly offset by proceeds from asset sales of \$151,000. Cash used in investing activities of \$5.7 million for fiscal 2004 consisted of payments for capital expenditures, partially offset by proceeds from sales of assets of \$54,000.

Cash provided by financing activities of \$5.3 million for fiscal 2006 consisted of proceeds of \$5.3 million from the exercise of stock options. Cash provided by financing activities of \$46.6 million for 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 \$3.1 million from the exercise of stock options and warrants, partially offset by debt issuance costs of \$433,000. Cash provided by financing activities for fiscal 2004 consisted of proceeds of \$12.5 million from the exercise of stock options and warrants, partially offset by deferred financing costs paid of \$64,000.

## ***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

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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 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 September 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 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 September 30, 2006, our cash and cash equivalents totaled \$30.0 million and our marketable securities totaled \$11.3 million. Our working capital at September 30, 2006 was \$50.9 million.



In order to become profitable, or to generate positive cash flows from operations, we must reduce operating expenses or achieve substantial revenue growth. Through fiscal 2006, we have completed a series of cost reduction actions which have improved our operating cost structure. We plan to continue with cost reduction actions in the first half of fiscal 2007. These expense reductions alone may not make us profitable or allow us to sustain profitability if it is achieved. 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. We may not be successful in achieving the



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

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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.

**Item 7A. *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 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 eighteen 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 the 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 September 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 Exchange Risk***

We transact business in various foreign currencies and we face foreign exchange 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 exchange 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 September 30, 2006, we held no foreign currency forward exchange contracts. Based on our overall currency rate exposure at September 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.

**Table of Contents****Item 8. Financial Statements and Supplementary Data****MINDSPEED TECHNOLOGIES, INC.****CONSOLIDATED BALANCE SHEETS**

	<b>September 30,</b>	
	<b>2006</b>	<b>2005</b>
	<b>(In thousands, except per share amounts)</b>	
<b>ASSETS</b>		
<b>Current Assets</b>		
Cash and cash equivalents	\$ 29,976	\$ 15,335
Marketable securities	11,260	40,094
Receivables, net of allowances for doubtful accounts of \$447 (2006) and \$462 (2005)	14,786	16,356
Inventories	19,008	10,730
Other current assets	3,690	3,389
Total current assets	78,720	85,904
Property, plant and equipment, net	12,961	14,890
Other assets	4,861	4,710
Total assets	\$ 96,542	\$ 105,504
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
<b>Current Liabilities</b>		
Accounts payable	\$ 10,639	\$ 9,776
Deferred revenue	5,047	3,452
Accrued compensation and benefits	5,038	6,722
Accrued income tax	2,761	425
Restructuring	1,667	3,442
Other current liabilities	2,688	2,755
Total current liabilities	27,840	26,572
Convertible senior notes	44,618	44,219
Other liabilities	608	887
Total liabilities	73,066	71,678
Commitments and contingencies (Notes 6 and 7)		
<b>Stockholders Equity</b>		
Preferred stock, \$0.01 par value: 25,000 shares authorized; no shares issued or outstanding		
Common stock, \$0.01 par value, 500,000 shares authorized; 110,702 (2006) and 103,852 (2005) issued shares	1,107	1,039

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Additional paid-in capital	250,602	237,003
Accumulated deficit	(212,566)	(188,052)
Accumulated other comprehensive loss	(15,667)	(16,164)
Total stockholders' equity	23,476	33,826
Total liabilities and stockholders' equity	\$ 96,542	\$ 105,504

See accompanying notes to consolidated financial statements.

**Table of Contents****MINDSPEED TECHNOLOGIES, INC.****CONSOLIDATED STATEMENTS OF OPERATIONS**

	<b>Years Ended September 30,</b>		
	<b>2006</b>	<b>2005</b>	<b>2004</b>
	<b>(In thousands, except per share amounts)</b>		
Net revenues	\$ 135,919	\$ 111,777	\$ 119,435
Cost of goods sold	43,592	33,704	35,149
Gross margin	92,327	78,073	84,286
Operating expenses:			
Research and development	64,104	71,355	79,582
Selling, general and administrative	46,970	41,871	46,845
Amortization of intangible assets		20,481	50,318
Special charges	2,550	5,999	387
Total operating expenses	113,624	139,706	177,132
Operating loss	(21,297)	(61,633)	(92,846)
Interest expense	(2,231)	(1,788)	
Other income, net	863	1,162	320
Loss before income taxes	(22,665)	(62,259)	(92,526)
Provision for income taxes	1,849	370	721
Net loss	\$ (24,514)	\$ (62,629)	\$ (93,247)
Net loss per share, basic and diluted	\$ (0.23)	\$ (0.61)	\$ (0.95)
Number of shares used in per share computation	105,537	102,190	98,140

See accompanying notes to consolidated financial statements.

**Table of Contents****MINDSPEED TECHNOLOGIES, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS**

	<b>Years Ended September 30,</b>		
	<b>2006</b>	<b>2005</b>	<b>2004</b>
	<b>(In thousands)</b>		
<b>Cash Flows From Operating Activities</b>			
Net loss	\$ (24,514)	\$ (62,629)	\$ (93,247)
Adjustments required to reconcile net loss to net cash used in operating activities:			
Depreciation	6,490	9,140	11,263
Amortization of intangible assets		20,481	50,318
Asset impairments		810	
Provision for bad debts	(15)	(160)	(118)
Inventory provisions	(586)	489	4,697
Stock compensation	7,516	588	270
Other noncash items, net	436	520	237
Changes in assets and liabilities:			
Receivables	1,585	3,422	(7,848)
Inventories	(7,692)	767	(12,648)
Accounts payable	863	(3,336)	5,002
Deferred revenue	1,595	(19)	298
Accrued expenses and other current liabilities	(335)	(376)	(1,621)
Other	(1,223)	94	181
Net cash used in operating activities	(15,880)	(30,209)	(43,216)
<b>Cash Flows From Investing Activities</b>			
Sales of assets		151	54
Capital expenditures	(4,488)	(3,980)	(5,791)
Purchases of available-for-sale marketable securities	(37,597)	(76,635)	
Sales of available-for-sale marketable securities	65,585	38,250	
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	25,225	(44,700)	(5,737)
<b>Cash Flows From Financing Activities</b>			
Sale of convertible senior notes		43,930	
Exercise of stock options and warrants	5,296	3,109	12,534
Deferred financing costs		(433)	(64)
Net cash provided by financing activities	5,296	46,606	12,470
Net increase (decrease) in cash and cash equivalents	14,641	(28,303)	(36,483)
Cash and cash equivalents at beginning of period	15,335	43,638	80,121



Cash and cash equivalents at end of period	\$ 29,976	\$ 15,335	\$ 43,638
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See accompanying notes to consolidated financial statements.

**Table of Contents****MINDSPEED TECHNOLOGIES, INC.****CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY AND COMPREHENSIVE LOSS**

	<b>Common Stock Shares</b>	<b>Common Stock Amount</b>	<b>Additional Paid-in Capital</b>	<b>Accumulated Deficit</b>	<b>Accumulated Other Comprehensive Loss</b>	<b>Total Stockholders Equity</b>
	(In thousands)					
Balance at September 30, 2003	93,545	\$ 935	\$ 215,334	\$ (32,176)	\$ (16,959)	\$ 167,134
Net loss				(93,247)		(93,247)
Currency translation adjustments					935	935
Comprehensive loss						(92,312)
Issuance of common stock	7,074	71	15,901			15,972
Compensation expense related to employee stock plans			133			133
Balance at September 30, 2004	100,619	1,006	231,368	(125,423)	(16,024)	90,927
Net loss				(62,629)		(62,629)
Currency translation adjustments					(140)	(140)
Comprehensive loss						(62,769)
Issuance of common stock	3,233	33	5,209			5,242
Compensation expense related to employee stock plans			426			426
Balance at September 30, 2005	103,852	1,039	237,003	(188,052)	(16,164)	33,826
Net loss				(24,514)		(24,514)
Currency translation adjustments					497	497
Comprehensive loss						(24,017)
Issuance of common stock	6,850	68	6,342			6,410
Common stock repurchased and retired	(115)	(1)	(258)			(259)
Compensation expense related to employee stock plans	115	1	7,515			7,516

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Balance at September 30, 2006	110,702	\$ 1,107	\$ 250,602	\$ (212,566)	\$ (15,667)	\$ 23,476
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See accompanying notes to consolidated financial statements.

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**MINDSPEED TECHNOLOGIES, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**1. Description of Business**

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 (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 (terminated December 2004), an Employee Matters Agreement, a Tax Allocation Agreement, a Transition Services Agreement and a Sublease.

***Basis of Presentation***

The consolidated 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 12), necessary to present fairly the Company's financial position, results of operations and cash flows.

**2. Summary of Significant Accounting Policies**

*Fiscal Periods* The Company maintains a fifty-two/fifty-three week fiscal year ending on the Friday closest to September 30. Fiscal years 2006, 2005, and 2004 comprised 52 weeks and ended on September 29, September 30, and October 1, respectively. For convenience, the accompanying consolidated financial statements have been shown as ending on the last day of the calendar month.

*Use of Estimates* The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Among the significant estimates affecting the financial statements are those related to the allowance for doubtful accounts, inventories, long-lived assets, stock compensation, income taxes, restructuring costs and litigation. On an ongoing basis, management reviews its estimates based upon currently available information. Actual results could differ materially from those estimates.

*Revenue Recognition* Revenues are recognized when the following fundamental criteria are met: (i) persuasive evidence of an arrangement exists; (ii) delivery has occurred; (iii) the 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. Certain product sales are made to electronic component distributors under agreements allowing for a right to return unsold products. Recognition of revenue on all sales to these distributors is deferred until the products are sold by the distributors to a third party. A provision for estimated sales returns and allowances from other customers is made in the same period

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**MINDSPEED TECHNOLOGIES, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

as the related revenues are recognized, based on historical experience or the specific identification of an event necessitating a reserve. Development revenue is recognized when services are performed and was not significant for any of the periods presented.

*Cash and Cash Equivalents* The Company considers all highly liquid investments with insignificant interest rate risk and original maturities of three months or less from the date of purchase to be cash equivalents. The carrying amounts of cash and cash equivalents approximate their fair values.

*Inventories* Inventories are stated at the lower of cost or market. Cost is computed using the average cost method on a currently adjusted standard basis (which approximates actual cost); market is based upon estimated net realizable value. The valuation of inventories at the lower of cost or market requires the use of estimates as to the amounts of current inventories that will be sold. These estimates are dependent on the Company's assessment of current and expected orders from its customers, and orders generally are subject to cancellation with limited advance notice prior to shipment.

*Property, Plant and Equipment* Property, plant and equipment is stated at cost. Depreciation is based on estimated useful lives (principally 10 to 27 years for buildings and improvements; 3 to 5 years for machinery and equipment; and the shorter of the remaining terms of the leases or the estimated economic useful lives of the improvements for land and leasehold improvements). Significant renewals and betterments are capitalized and replaced units are written off. Maintenance and repairs are charged to expense.

*Intangible Assets* Intangible assets consist mainly of patents and developed technology and are amortized on a straight-line basis over estimated useful lives of 2 to 8 years.

*Impairment of Long-Lived Assets* The Company continually monitors events or changes in circumstances that could indicate that the carrying amount of long-lived assets to be held and used, including intangible assets, may not be recoverable. The determination of recoverability is based on an estimate of undiscounted future cash flows resulting from the use of the asset and its eventual disposition. When impairment is indicated for a long-lived asset, the amount of impairment loss is the excess of net book value over fair value. Long-lived assets to be disposed of are reported at the lower of carrying amount or fair value less costs to sell. During fiscal 2005, the Company recorded impairment charges as discussed in Note 12. As of September 30, 2006, the Company identified no circumstances that indicated a potential impairment of any of its long-lived assets.

*Foreign Currency Translation and Remeasurement* The Company's foreign operations are subject to exchange rate fluctuations and foreign currency transaction costs. The functional currency of the Company's principal foreign subsidiaries is the local currency. Assets and liabilities denominated in foreign functional currencies are translated into U.S. dollars at the rates of exchange in effect at the balance sheet dates and income and expense items are translated at the average exchange rates prevailing during the period. The resulting foreign currency translation adjustments are accumulated as a component of other comprehensive income. For the remainder of the Company's foreign subsidiaries, the functional currency is the U.S. dollar. Inventories, property, plant and equipment, cost of goods sold and depreciation for those operations are remeasured from foreign currencies into U.S. dollars at historical exchange rates; other accounts are translated at current exchange rates. Gains and losses resulting from those remeasurements are included in earnings. Gains and losses resulting from foreign currency transactions are recognized currently in earnings.

*Research and Development* Research and development costs, other than software development costs, are expensed as incurred. Development costs for software to be sold or marketed are capitalized following attainment of technological feasibility. No development costs that qualify for capitalization were incurred during any of the periods presented.

*Product Warranties* The Company's products typically carry a warranty for periods of up to five years. The Company establishes reserves for estimated product warranty costs in the period the related revenue is recognized, based on historical experience and any known product warranty issues.

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**MINDSPEED TECHNOLOGIES, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

*Recent Accounting Standards* 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. 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 de-recognition, 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 our first fiscal quarter ended December 31, 2007 of fiscal 2008. The Company is in the process of evaluating the effect, if any, the adoption of FIN 48 will have on its financial statements.

In September 2006, the SEC released Staff Accounting Bulletin (SAB) No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*, which addresses how uncorrected errors in previous years should be considered when quantifying errors in current-year financial statements. SAB 108 requires registrants to consider the effect of all carry over and reversing effects of prior-year misstatements when quantifying errors in current-year financial statements. SAB 108 allows registrants to record the effects of adopting the guidance as a cumulative-effect adjustment to retained earnings. The Company will adopt SAB 108 as of the beginning of fiscal 2007 and does not expect that the adoption of SAB 108 will have a material impact on its financial condition or results of operations.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurement (SFAS 157), which defines fair value, establishes a framework for measuring fair value and expands disclosures about assets and liabilities measured at fair value. The Company will be required to adopt SFAS 157 in the first quarter of fiscal 2009. Management is currently evaluating the requirements of SFAS 157 and has not yet determined the impact on the consolidated financial statements.

*Stock-Based Compensation* Effective October 1, 2005, the Company adopted SFAS No. 123 (revised 2004), Share-Based Payment (SFAS 123R) to account for stock-based compensation. SFAS 123R requires that the Company 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. The Company estimates the fair value of stock options granted using the Black-Scholes option pricing model. The use of the Black-Scholes model requires 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. Judgment is 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. The financial statements include amounts that are based on the Company's best estimates and judgments. Prior to fiscal 2006, the Company accounted for stock-based compensation using the



intrinsic value method prescribed in Accounting Principles Board ( APB ) Option No. 25 Accounting for Stock Issued to Employees (see Note 10).

*Income Taxes* The provision for income taxes is determined in accordance with SFAS No. 109, Accounting For Income Taxes. Deferred tax assets and liabilities are determined based on the temporary differences between the financial reporting and tax bases of assets and liabilities, applying enacted statutory tax rates in effect for the

**Table of Contents****MINDSPEED TECHNOLOGIES, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

year in which the differences are expected to reverse. A valuation allowance is recorded when it is more likely than not that some or all of the deferred tax assets will not be realized.

*Loss Per Share* Basic loss per share is based on the weighted-average number of shares of common stock outstanding during the period. Diluted loss per share also includes the effect of stock options, warrants and other common stock equivalents outstanding during the period if such securities are dilutive. Because the Company incurred a net loss in each of the periods presented, the potential dilutive effect of the Company's outstanding stock options, stock warrants and convertible senior notes was not included in the computation of diluted loss per share because these securities were antidilutive. For periods prior to the Distribution, the weighted-average number of shares outstanding is based on Conexant's weighted-average shares outstanding.

*Concentrations* Financial instruments that potentially subject the Company to a concentration of credit risk consist principally of cash and cash equivalents, marketable securities and trade accounts receivable. Cash and cash equivalents consist of demand deposits and money market funds maintained with several financial institutions. Deposits held with banks may exceed the amount of insurance provided on such deposits. Generally, these deposits may be redeemed upon demand and are maintained with high-credit quality financial institutions and therefore have minimal credit risk. Marketable securities consist of U.S. Treasury securities and auction rate securities, all of which are high investment grade. The Company, by policy, limits the amount of credit exposure through diversification and investment in highly rated securities. The Company's trade accounts receivable primarily are derived from sales to manufacturers of network infrastructure equipment and electronic component distributors. Management believes that credit risks on trade accounts receivable are moderated by the diversity of its end customers and geographic sales areas. The Company performs ongoing credit evaluations of its customers' financial condition and requires collateral, such as letters of credit and bank guarantees, whenever deemed necessary.

The following individual customers accounted for 10% or more of net revenues:

	<b>2006</b>	<b>2005</b>	<b>2004</b>
Customer A	17%	16%	16%
Customer B	11%	14%	8%
Customer C	11%	12%	8%
Customer D	7%	11%	9%
Customer E			12%

The following individual customers accounted for 10% or more of total accounts receivable at fiscal year ends:

	<b>2006</b>	<b>2005</b>
Customer A	21%	14%
Customer C	16%	10%
Customer F	11%	19%
Customer G	6%	17%

*Supplemental Cash Flow Information* Interest paid was \$1.7 million and \$0.8 million for fiscal 2006 and fiscal 2005, respectively; the Company paid no interest during fiscal 2004. Income taxes paid, net of refunds received, were (\$36,000), \$400,000 and \$300,000 million during fiscal 2006, 2005 and 2004, respectively.

*Comprehensive Loss* Accumulated other comprehensive loss at September 30, 2006 and 2005 consists of foreign currency translation adjustments. Foreign currency translation adjustments are not presented net of any tax effect as the Company does not expect to incur any tax liability or realize any benefit related thereto.

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

Table of Contents**MINDSPEED TECHNOLOGIES, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****3. Supplemental Financial Statement Data***Marketable Securities*

Marketable securities at fiscal year ends consist of the following (in thousands):

	2006		2005	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
<i>Available-for-sale securities:</i>				
Auction rate securities	\$ 10,400	\$ 10,400	\$ 38,385	\$ 38,385
<i>Held-to-maturity securities:</i>				
U.S. Treasury securities	\$ 860	\$ 858	\$ 2,546	\$ 2,546
Less amounts classified as noncurrent			(837)	(825)
	\$ 860	\$ 858	\$ 1,709	\$ 1,701

Available-for-sale marketable securities consist of auction rate securities with interest at rates that are reset periodically (generally every seven or twenty-eight days), each having contractual maturity dates in excess of ten years. These securities are 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 September 30, 2006, there are no unrealized holding gains or losses. The Company classifies all 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.

Held-to-maturity marketable securities consist of U.S. Treasury securities having an aggregate face amount of approximately \$860,000 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 fourth scheduled interest payment on the notes when due. Consequently, these securities are classified as held-to-maturity securities and are recorded at their amortized cost.

*Inventories*

Inventories at fiscal year ends consist of the following (in thousands):

	2006	2005
Work-in-process	\$ 9,120	\$ 5,422
Finished goods	9,888	5,308

\$ 19,008      \$ 10,730

The Company assesses the recoverability of inventories through an ongoing review of inventory levels in relation to sales backlog and forecasts, product marketing plans and product life cycles. When the inventory on hand exceeds the foreseeable demand, the value of inventory that at the time of the review is not expected to be sold is written down. The amount of the write-down is the excess of historical cost over estimated realizable value (generally zero). Once established, these write-downs are considered permanent adjustments to the cost basis of the excess inventory.

The assessment of the recoverability of inventories, and the amounts of any write-downs, are based on currently available information and assumptions about future demand (generally over twelve months) and market conditions. Demand for the Company's 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****MINDSPEED TECHNOLOGIES, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The Company may retain and make available for sale some or all of the inventories which have been written down. In the event that actual demand is higher than originally projected, the Company may be able to sell a portion of these inventories in the future. The Company generally scraps inventories which have been written down and are identified as obsolete.

Our gross margin included a benefit of \$5.5 million (2006), \$8.7 million (2005) and \$9.0 million (2004) from the sale of inventories that we had written down to a zero cost basis during fiscal 2001. As of September 30, 2006, the Company continued to hold inventories with an original cost of \$12.4 million which were previously written down to a zero cost basis.

***Property, Plant and Equipment***

Property, plant and equipment at fiscal year ends consists of the following (in thousands):

	<b>2006</b>	<b>2005</b>
Machinery and equipment	\$ 69,995	\$ 68,868
Leasehold improvements	3,489	3,982
Construction in progress	1,722	706
	75,206	73,556
Accumulated depreciation and amortization	(62,245)	(58,666)
	\$ 12,961	\$ 14,890

***Intangible Assets***

Intangible assets consisting of developed technology (approximately \$228 million), customer base (approximately \$28 million) and other intangibles (approximately \$11 million) were amortized over periods averaging approximately five years for each major asset class and extending to various dates through June 2005. Amortization of intangible assets was zero for fiscal 2006 because the remainder of the intangible assets became fully amortized during fiscal 2005, reducing their carrying value to zero. Amortization of intangible assets totaled \$20.5 million (2005) and \$50.3 million (2004).

**4. Income Taxes**

The components of the provision for income taxes are as follows (in thousands):

	<b>2006</b>	<b>2005</b>	<b>2004</b>
Current:			

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United States	\$	\$	\$
Foreign	2,137	24	357
State and local	10	15	5
Total current	2,147	39	362
Deferred:			
United States			
Foreign	(298)	331	359
State and local			
Total deferred	(298)	331	359
	\$ 1,849	\$ 370	\$ 721

**Table of Contents****MINDSPEED TECHNOLOGIES, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

A reconciliation of income taxes computed at the U.S. federal statutory income tax rate to the provision for income taxes on continuing operations follows (in thousands):

	<b>2006</b>	<b>2005</b>	<b>2004</b>
U.S. federal statutory tax at 35%	\$ (7,933)	\$ (21,791)	\$ (32,384)
State taxes, net of federal effect	(3,612)	(1,563)	(1,165)
Foreign income taxes in excess of U.S.	(524)	(866)	3,308
Research and development credits	(3,443)	(2,819)	(1,864)
Valuation allowance	17,187	26,836	32,783
Other	174	573	43
Provision for income taxes	\$ 1,849	\$ 370	\$ 721

Income (loss) before income taxes consists of the following components (in thousands):

	<b>2006</b>	<b>2005</b>	<b>2004</b>
United States	\$ (29,418)	\$ (65,749)	\$ (84,946)
Foreign	6,753	3,490	(7,580)
	\$ (22,665)	\$ (62,259)	\$ (92,526)

Deferred income tax assets and liabilities at fiscal year-ends consist of the tax effects of temporary differences related to the following (in thousands):

	<b>2006</b>	<b>2005</b>
Deferred tax assets:		
Inventories	\$ 16,746	\$ 17,151
Deferred revenue	1,984	1,357
Accrued compensation and benefits	1,155	1,641
Product returns and allowances	674	808
Net operating losses	221,294	207,804
Research and development and investment credits	31,932	26,783
Foreign deferred taxes	1,150	852
Other	7,517	6,013
Valuation allowance	(268,144)	(250,957)



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Total deferred tax assets	14,308	11,452
Deferred tax liabilities:		
Intangible assets		
Property, plant and equipment	1,283	674
Deferred state taxes	11,875	9,926
Other		
Total deferred tax liabilities	13,158	10,600
Net deferred tax assets	\$ 1,150	\$ 852

Based upon the Company's operating losses and expected future operating results, management determined that it is more likely than not that the U.S. federal and state deferred tax assets as of September 30, 2006 and 2005

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**MINDSPEED TECHNOLOGIES, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

will not be realized through the reduction of future income tax payments. Consequently, the Company has established a valuation allowance for its net U.S. federal and state deferred tax assets as of those dates.

Through the Distribution date, Mindspeed's results of operations were included in Conexant's consolidated federal and state income tax returns. The provision for income taxes and the related deferred tax assets and liabilities for periods prior to the Distribution were calculated as if Mindspeed had filed separate tax returns as an independent company.

In connection with the Distribution, Mindspeed and Conexant entered into a tax allocation agreement which provides, among other things, for the allocation between Conexant and Mindspeed of federal, state, local and foreign tax liabilities relating to Mindspeed. The tax allocation agreement also allocates the liability for any taxes that may arise in connection with the Distribution. The tax allocation agreement generally provides that Conexant will be responsible for any such taxes. However, Mindspeed will be responsible for any taxes imposed on Mindspeed, Conexant or Conexant stockholders if either the Distribution fails to qualify as a reorganization for U.S. federal income tax purposes or the distribution of Mindspeed Technologies common stock is disqualified as a tax-free transaction to Conexant for U.S. federal income tax purposes and such failure or disqualification is attributable to post-Distribution transaction actions by Mindspeed, its subsidiaries or its stockholders.

As of September 30, 2006, Mindspeed had U.S. federal net operating loss carryforwards of approximately \$603.2 million, which expire at various dates from 2010 through 2027, and aggregate state net operating loss carryforwards of approximately \$117.8 million, which expire at various dates from 2007 through 2027. Mindspeed also has U.S. federal and state research and development tax credit carryforwards of approximately \$13.5 million and \$18.4 million, respectively. The U.S. federal credits expire at various dates from 2010 through 2027, while the state credits have no expiration date.

The deferred tax assets as of September 30, 2006 include a deferred tax asset of \$11.5 million representing net operating losses arising from the exercise of stock options by Mindspeed employees. To the extent the Company realizes any tax benefit for the net operating losses attributable to the stock option exercises, such amount would be credited directly to stockholders' equity.

The Company has not provided for U.S. taxes or foreign withholding taxes on approximately \$560,000 of undistributed earnings from its foreign subsidiaries because such earnings are to be reinvested indefinitely. If these earnings were distributed, foreign tax credits may become available under current law to reduce the resulting U.S. income tax liability.

**5. Convertible Senior Notes**

In December 2004, the Company 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 of the Company, 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. The Company 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 the Company's common stock. Upon conversion, the Company may, at its option, elect to deliver cash in lieu of shares of its 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

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**MINDSPEED TECHNOLOGIES, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

of the indenture to reflect stock dividends, stock splits, issuances of rights to purchase shares of common stock and certain other events.

If the Company undergoes certain fundamental changes (as defined in the indenture), holders of notes may require the Company 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, the Company 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), the Company 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 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, the Company's contingent obligation to issue additional shares or make an additional cash payment upon conversion following a fundamental change is an embedded derivative. As of September 30, 2006, the estimated fair value of the Company's liability under the fundamental change adjustment was not significant.

In connection with the sale of the notes, the Company granted the purchasers certain registration rights. The Company's Form S-3 registration statement covering the resale of the notes and the sale of shares issuable upon conversion of the notes was declared effective by the SEC on April 6, 2005.

Upon completion of the sale of the notes, the \$50 million Credit Agreement with Conexant was terminated. The Company had made no borrowings under the credit facility, and no portion of the related warrant is, or will become, exercisable.

As of September 30, 2006, the estimated fair value of the convertible senior notes was approximately \$49.0 million.

**6. Commitments**

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 \$3.9 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 \$6.7 million annually (a total of \$11.8 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.

The Company leases its 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.

Rental expense was approximately \$7.7 million (2006), \$7.3 million (2005), and \$6.8 million (2004). Rental expense includes \$6.5 million (2006), \$3.7 million (2005), and \$4.5 million (2004) paid to Conexant under the

**Table of Contents****MINDSPEED TECHNOLOGIES, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Sublease. As of September 30, 2006, the Company's minimum future obligations under operating leases (including the estimated minimum future obligation under the Sublease) are as follows (in thousands):

**Fiscal Year**

2007	\$ 9,217
2008	6,374
2009	912
2010	406
2011	205
Thereafter	530
Total minimum future lease payments	\$ 17,644

The minimum future lease payments as of September 30, 2006 include an aggregate of \$0.9 million relating to facilities no longer occupied by the Company, which is included in the restructuring liability in the accompanying consolidated balance sheets.

**7. 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 Mindspeed.

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.

**8. Guarantees**

The Company has made guarantees and indemnities, under which it may be required to make payments to a guaranteed or indemnified party, in relation to certain transactions. In connection with the Distribution, the Company generally assumed responsibility for all contingent liabilities and then-current and future litigation against Conexant or its subsidiaries related to Mindspeed. The Company may also be responsible for certain federal income tax liabilities under the tax allocation agreement between Mindspeed and Conexant, which provides that the Company will be responsible for certain taxes imposed on Mindspeed, Conexant or Conexant stockholders. In connection with the sales of its products, the Company provides intellectual property indemnities to its customers. In connection with certain facility leases, the Company has indemnified its lessors for certain claims arising from the facility or the lease. The

Company indemnifies its directors, 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 guarantees and indemnities to customers in connection with product sales generally are subject to limits based upon the amount of the related product sales. Some customer guarantees and indemnities, and the majority of other guarantees and indemnities, do not provide for any limitation of the maximum potential future payments the Company could be obligated to make. The Company has not recorded any liability for these guarantees and indemnities in the accompanying consolidated balance sheets.

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**MINDSPEED TECHNOLOGIES, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**9. Capital Stock**

The Company's authorized capital consists of 500,000,000 shares of common stock, par value \$0.01 per share, and 25,000,000 shares of preferred stock, par value \$0.01 per share, of which 2,500,000 shares are designated as Series A junior participating preferred stock (Junior Preferred Stock).

The Company has a preferred share purchase rights plan to protect stockholders' rights in the event of a proposed takeover of the Company. Pursuant to the preferred share purchase right (a Right) attached to each share of common stock, the holder may, in certain takeover-related circumstances, become entitled to purchase from the Company 1/100th of a share of Junior Preferred Stock at a price of \$20, subject to adjustment. Also, in certain takeover-related circumstances, each Right (other than those held by an acquiring person) will generally be exercisable for shares of the Company's common stock or stock of the acquiring person having a then-current market value of twice the exercise price. In certain events, each Right may be exchanged by the Company for one share of common stock or 1/100th of a share of Junior Preferred Stock. The Rights expire on June 26, 2013, unless earlier exchanged or redeemed at a redemption price of \$0.01 per Right, subject to adjustment.

***Warrants***

In the Distribution, Mindspeed issued to Conexant a warrant to purchase 30 million shares of Mindspeed common stock at a price of \$3.408 per share, exercisable through June 27, 2013. The \$89 million fair value of the warrant (estimated by management at the time of the Distribution using the Black-Scholes option pricing model) was recorded as a return of capital to Conexant. As of September 30, 2006, the entire warrant remains outstanding.

The warrant held by 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. In the event that the Company issues, or is deemed to have issued, shares of its common stock, or securities convertible into its common stock, at prices below the current market price of its 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 the common stock at the time of the issuance of such securities.

Also in the Distribution, as a result of adjustments made to an outstanding warrant to purchase shares of Conexant common stock, Mindspeed issued to Jazz Semiconductor, Inc. (Jazz) a warrant to purchase 1,036,806 shares of Mindspeed common stock, at a price of \$2.5746 per share. During fiscal 2005, the Company issued 478,405 shares of its common stock upon the exercise of all remaining warrants held by Jazz for aggregate proceeds of \$1.2 million.

**10. 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.

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

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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. The Company elected the transition method described in FASB Staff Position ( FSP ) FAS 123R-3 related to accounting for the tax effects of share-based payment awards to employees.

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 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>2006</b>	<b>2005</b>	<b>2004</b>
Weighted-average fair value of options granted	\$ 1.53	\$ 1.05	\$ 2.73
Weighted-average assumptions:			
Expected volatility	77%	80%	98%
Dividend yield			
Expected option life	3.4 years	2.2 years	3.3 years
Risk-free interest rate	4.7%	3.9%	2.7%

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 since our spin-off from Conexant. 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.

Stock-based compensation expense related to employee stock options and restricted stock under SFAS 123R for fiscal 2006 was allocated as follows (in thousands):

Cost of goods sold	\$ 399
Research and development	2,757
Selling, general and administrative	4,040
Special charges	320

Total stock-based compensation expense

\$ 7,516

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Had the Company recorded compensation expense using the accounting method recommended by SFAS No. 123 for prior fiscal years ended September 30, 2005 and 2004, net income and net income per share would have been approximated in the following (in thousands, except per share amounts):

	<b>2005</b>	<b>2004</b>
Net loss, as reported	\$ (62,629)	\$ (93,247)
Stock-based employee compensation expense included in the determination of reported net loss	(426)	(133)
Stock-based employee compensation expense determined under the fair value method	11,890	26,158
Pro forma net loss	\$ (74,093)	\$ (119,272)
Net loss per share, basic and diluted:		
As reported	\$ (0.61)	\$ (0.95)
Pro forma	\$ (0.73)	\$ (1.22)

***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 September 30, 2006, an aggregate of 5.6 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 1.3 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.

Table of Contents**MINDSPEED TECHNOLOGIES, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)*****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):

	<b>Number of Shares</b>	<b>Weighted Average Exercise Price</b>	<b>Weighted Average Remaining Contractual Term</b>	<b>Aggregate Intrinsic Value</b>
Outstanding at September 30, 2003	30,466	\$ 2.07		
Granted	2,839	4.31		
Exercised	(5,516)	2.04		\$ 30,500,000
Forfeited or expired	(930)	2.53		
Outstanding at September 30, 2004	26,859	2.30		
Excercisable at September 30, 2004	17,722	2.13		
Granted	3,143	2.26		
Exercised	(1,188)	1.59		\$ 900,000
Forfeited or expired	(2,734)	2.52		
Outstanding at September 30, 2005	26,080	2.30		
Excercisable at September 30, 2005	19,104	2.21		
Granted	1,023	2.71		
Exercised	(3,009)	1.76		\$ 4,400,000
Forfeited or expired	(1,898)	3.18		
Outstanding at September 30, 2006	22,196	\$ 2.32	4.3 years	\$ 1,900,000
Excercisable at September 30, 2006	18,672	\$ 2.26	3.9 years	\$ 1,400,000

As of September 30, 2006, there was unrecognized compensation expense of \$2.1 million related to unvested stock options, which the Company expects to recognize over a weighted-average period of 2.3 years.

The following table summarizes all options to purchase Mindspeed common stock outstanding at September 30, 2006 (shares in thousands):

<b>Range of Exercise Prices</b>	<b>Number of Shares</b>	<b>Outstanding Average Remaining Contractual Life (Years)</b>	<b>Weighted-Average Exercise Price</b>	<b>Number of Shares</b>	<b>Exercisable Weighted-Average Exercise Price</b>
\$0.25 - \$1.58	2,673	4.0	\$ 1.04	1,826	\$ 1.00
1.61 - 2.27	7,119	2.2	1.83	6,716	1.82
2.28 - 2.73	9,100	4.0	2.45	8,173	2.43
2.79 - 4.41	2,862	3.1	3.55	1,655	3.65
4.46 - 23.29	442	2.3	7.50	302	7.71
0.25 - 23.29	22,196	3.2	2.32	18,672	2.26

**Table of Contents****MINDSPEED TECHNOLOGIES, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The outstanding stock options include options held by Mindspeed employees to purchase an aggregate of 14.7 million shares of Mindspeed common stock, which are summarized in the following table (shares in thousands):

<b>Range of Exercise Prices</b>	<b>Number of Shares</b>	<b>Outstanding Average Remaining Contractual Life (Years)</b>	<b>Weighted-Average Exercise Price</b>	<b>Exercisable Number of Shares</b>	<b>Weighted-Average Exercise Price</b>
\$0.25 - \$1.51	1,243	4.1	\$ 1.10	751	\$ 1.03
1.61 - 2.27	4,177	2.8	1.83	3,781	1.82
2.28 - 2.73	6,620	4.6	2.48	5,719	2.45
2.82 - 4.41	2,346	4.4	3.45	1,160	3.49
4.46 - 16.98	352	4.2	7.36	222	7.63
0.25 - 16.98	14,738	4.1	2.45	11,633	2.36

**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.

Restricted stock grants totaled 4.2 million shares (2006), 421,000 shares (2005) and 51,000 shares (2004). In fiscal 2006, new awards of stock-based compensation have principally consisted of restricted stock awards. 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):



	<b>Number of Shares</b>	<b>Weighted- Average Grant Date Fair Value</b>
Nonvested shares at September 30, 2005	423	\$ 2.13
Granted	4,165	\$ 2.57
Vested	(541)	\$ 2.42
Forfeited	(376)	\$ 2.54
Nonvested shares at September 30, 2006	3,671	\$ 2.54

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The total fair value of shares vested during the year ended September 30, 2006 was \$1.5 million. As of September 30, 2006 there was unrecognized compensation expense of \$3.8 million related to unvested restricted stock awards, which the Company expects to recognize over a weighted-average period of 2.6 years.

***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. Through July 2005, purchases were made at specified intervals during a 24-month offering period at 85% of the lower of the fair market value on the first day of the 24-month offering period or on the purchase date. Beginning in August 2005, 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 years ended September 30, 2006 and 2005, the Company issued 108,000 and 666,000 shares of its common stock under the employee stock purchase plan for net proceeds of \$298,000 and \$1.1 million, respectively.

**11. Employee Benefit Plans**

The Company sponsors a 401(k) retirement savings plan for its eligible employees. Prior to the Distribution, Mindspeed employees were eligible to participate in similar plans sponsored by Conexant. The Company matches a portion of employee contributions and funds the matching contribution in shares of its common stock. The Company issued 331,000 shares (2006), 483,000 shares (2005), and 220,000 shares (2004) of its common stock to fund the matching contributions. The Company recognized expenses under the retirement savings plans, including amounts allocated from Conexant, of \$0.8 million (2006), \$0.9 million (2005), and \$1.2 million (2004).

**12. Special Charges**

Special charges consist of the following:

	2006	2005	2004
	(In millions)		
Asset impairments	\$	\$ 0.8	\$
Restructuring charges	2.6	5.2	0.4
	\$ 2.6	\$ 6.0	\$ 0.4

***Asset Impairments***

During fiscal 2005, the Company recorded asset impairment charges totaling \$810,000 related to property and equipment that the Company determined to abandon or scrap, including assets associated with the closure of our former design centers in Herzlia, Israel and Lisle, Illinois.

The Company continually monitors 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, the Company implemented a restructuring plan under which the Company reduced our workforce by approximately 21 employees. The affected employees included approximately 9 persons in research and development, 6 in sales and marketing and 6 in general and administrative functions. In July 2006, the Company continued this restructuring plan and reduced our workforce by an additional

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19 employees. The affected employees included approximately 17 persons in research and development and 2 in sales and marketing. In connection with the 2006 restructuring plan, the Company recorded \$2.4 million of restructuring charges for fiscal 2006. These restructuring charges included \$2.1 million of severance benefits payable to 40 employees and \$294,000 for the value of stock-based compensation awards that vest without future service to us.

The Company expects that the workforce reductions will reduce our quarterly operating expenses by approximately \$1.7 million, including approximately \$1.4 million 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 2007 first quarter. However, the Company intends 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 September 30, 2006 are as follows (in thousands):

	<b>Workforce Reductions</b>
Charged to costs and expenses	\$ 2,406
Cash payments	(1,215)
Non-cash charges	(294)
Restructuring balance, September 30, 2006	\$ 897

*Mindspeed 2004 Restructuring Plan* In October 2004, the Company 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 the Company believed 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. The Company completed substantially all of these actions during fiscal 2005, reducing our workforce by approximately 90 employees.

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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 fiscal 2006, the Company recorded additional charges of \$277,000 for severance and related benefits payable to the affected employees. Activity and liability balances related to the Mindspeed 2004 restructuring plan through September 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	277		277
Cash payments	(1,058)	(752)	(1,810)
Restructuring balance, September 30, 2006	\$ 56	\$ 219	\$ 275

*Other Restructuring Plans* In fiscal 2001, 2002 and 2003, the Company 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 year ended September 30, 2006, the Company made cash payments of \$1.5 million under these restructuring plans and reversed \$134,000 of previously accrued costs and expenses related to contractual obligations. As of September 30, 2006, our remaining liabilities under these restructuring plans totaled \$500,000, representing amounts payable under non-cancelable leases, severance benefits to affected employees and other contractual commitments.

As of September 30, 2006, the Company has a remaining accrued restructuring balance for all restructuring plans totaling \$1.7 million (classified as a current liability), principally representing obligations under non-cancelable leases and other contractual commitments. The Company expects to pay these obligations over their respective terms, which expire at various dates through fiscal 2007. The payments will be funded from available cash balances and funds from product sales and are not expected to impact significantly our liquidity.

**13. Related Party Transactions**

The Company leases its headquarters and principal design center in Newp